AMERICA

AND THE

BALANCE SHEET OF EUROPE

By

JOHN FOSTER BASS, LL.B., F.R.G.S.
Author of "The Peace Tangle"

And

HAROLD GLENN MOULTON, Ph.D.
Author of "The Financial Organization of Society," etc.

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If the broken countries of Europe are not restored, even the states still solvent will slip one by one into the general ruin.—RIGHT HON. REGINALD MCKENNA, Chairman, London Joint City and Midland Bank, Ltd.; ex-Chancellor of the British Exchequer.

PREFACE

Many people still believe that present disturbed economic conditions will soon be adjusted, that problems will solve themselves—particularly if we refuse to look facts in the face and to admit that conditions are serious. It is urged that business is, after all, merely a matter of psychology and that if we will only banish pessimism and smile confidently though conditions look dark, everything will shortly automatically adjust itself. This economic hypnotism is supposed to have remarkable restorative powers notwithstanding the fact that such things as the foreign exchanges and national budgets have hitherto proved impervious to psychopathic suggestion. In any event, it is believed that time is still the great healer and that somehow or other the world will blunder through to "normalcy."

The purpose of this volume is: first, to determine the economic and political status of Europe at the present time; second, to appraise the probable effects of the international settlements (including reparations) that have recently been made; and third, to suggest in broad outlines an international policy such as it is believed the situation demands.

It is time that the United States cease drifting with reference to international affairs. It is time that we examine, in a spirit of scientific inquiry, the international economic and political situation as it stands today. It is time that we attempt to ascertain the probable results of recent political and economic developments in Europe. It is time that through study and discussion we begin to clarify our ideas and to formulate an American foreign policy—a policy, moreover, that will be directed not merely at this or that particular issue as it arises, but that will be based upon a con-

sideration of the entire international situation conceived as one problem. It is hoped that this volume may contribute something toward a clarification of the issues involved and, if ever so little, toward the formulation of such a policy.

The authors take this opportunity of expressing their indebtedness to the host of people who through discussion and counsel have contributed to make the book of whatever merit it may be. We are particularly indebted for the information gathered in connection with the London meetings of the International Chamber of Commerce. In view of the rather striking conclusions that we have reached, it has proved a comfort to know that they are shared by many of the leaders of European economic thought.

John Foster Bass
Harold G. Moulton

The University of Chicago
November 24, 1921.

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Part I—The Situation As It Really Is

CHAPTER I

TESTS OF EUROPEAN CONDITIONS

Reversion to Isolation Policy

It was doubtless inevitable that the American people, irritated by European war experiences and disillusioned by the terms of the peace settlement, should revert to the traditional policy of American isolation. It is just as inevitable, however, that under the compulsion of irresistible economic forces the pendulum will again swing in the opposite direction—toward co-operation with Europe in the solution of post-war problems. Europe as the controlling element in the world economic situation is a fact which simply will not down. Regardless of the decision of the American people in last year's elections against further European entanglements, and notwithstanding the more recent presidential announcement that the first and most important task of the present administration is that of tidying up our own dooryard, the paramount American issue of the next four years will be the European question. We could afford to forget about Europe during the post-war inflation period of last year; but now that the fateful processes of economic readjustment are at last under way, we shall find European conditions

will largely determine American conditions. The outstanding problem of the world today is the formulation of a program of international action designed to prevent progressive economic and social decadence.

The striking events of the past five years have tended to dull the apperceptive qualities of mankind. Events are daily chronicled in the newspapers which would have shocked the public consciousness five years ago; but they now pass unheeded by a public whose attention has been jaded to satiety by the abnormal events of the war and of the years that have followed. As a nation, we are so particularly weary of all things European that the vast majority of people in the United States now refuse to give European affairs so much as a passing thought.

Even among those who do give heed to international economic conditions, there is usually a tendency—born of a lack of understanding of the complex interrelations of the economic organization of the modern world—to seize upon every particular development or manifestation as proof positive that conditions are distinctly on the mend. Such developments are all too often mere surface phenomena, lulling us into a sense of economic security, while underneath, silently but irresistibly, are being organized the forces of economic and social dissolution.

Economic Interdependence of Nations

The confusion in American public opinion concerning the economic situation in Europe and its relation to American conditions is one of the most serious obstacles to world recovery from the disastrous effects of the war. If constructive assistance in the re-establishment of world finance and world commerce is to be rendered by the United States, we must first understand precisely what the present economic condition of Europe is; we must know what is to be

remedied or re-established. And if the support of this country is to be enlisted in any comprehensive plans for international, economic reorganization, the rank and file of people must first be given a clear appreciation of the bearing of present European conditions upon conditions within the United States; they must be made to realize the full significance of the words, "The world is an economic unit; nations are economically interdependent." The first part of this volume is therefore devoted to showing the true economic status of Europe today and the probable effects of European developments upon the economic welfare of the United States.

Diversity of Views

As a matter of fact, one finds alike in the effervescent comments of returning tourists and in the soberer statements of financial and economic writers, the greatest diversity of view as to present conditions abroad. These sharp differences of opinion are largely to be explained by the selection of different facts or data for the purpose of testing conditions and by varying interpretations of the meaning of the data selected. When the economic physician attempts to appraise the condition of diseased Europe, he must not only look for the symptoms which are the real indexes of vital conditions, but must also be able to give balanced weight to each and to distinguish those indicating permanent underlying conditions from those reflecting nervous shock or temporary exhilaration.

Facts—admitted facts—are frequently presented as conclusive evidence of improving conditions when in reality they are merely evidences of disordered economic life. For example, it is frequently pointed out that European capitals were never more gay, never more luxurious, or never more apparently prosperous than now. The truth is that the more

disorganized is the currency and the more unsettled are prices, the greater is the tendency to wild extravagance and utter disregard of values. Examples of this kind, though quickly forgotten, are frequent in history; where peoples drugged with illimitable quantities of paper money have appeared to be prosperous and have continued to live extravagantly almost to the very moment of monetary and economic collapse. This was, of course, notoriously the case in the well-known John Law paper money episode in France in 1719. A writer of the time states: "Plenty displayed herself through all the towns and all the country . . . in a word, riches flowed in from every quarter; gold, silver, precious stones, ornaments of every kind which contribute to luxury and magnificence, came to us from every country in Europe." This was written only a year before the final collapse of the famous Mississippi bubble.

"Calamity Boom"

Again, it is often pointed out that there has been a great rise in the prices of securities since the Armistice and that speculation is rampant, particularly in Germany. Once more, the truth is that speculation and rising security prices are directly attributable to the unsettlement of financial conditions and the inflation of paper currency. One is reminded, in this connection, of the period of paper money inflation in Revolutionary France in 1791, which ultimately culminated in financial disaster. Of this cataclysm, the historian White writes: "With the masses of the people the purchase of every article of supply became a speculation—a speculation in which the professional speculator had an immense advantage over the buyer. Says the most brilliant apologist for French Revolutionary statesmanship, 'Commerce is dead; betting took its place.' "

While speculation in some European countries is now

less rife than it was in 1919–1920, in others, where inflation has continued, it is now more rampant than ever. At the present moment Berlin is witnessing what is there known as the "Calamity Boom." No more fitting characterization could be given to the skyrocketing of security prices which accompanies the outpouring of paper currency during the period preceding the inevitable collapse of the whole tissue of artificial valuations.

Misleading Statistics

Similarly, statistics showing an increase in national wealth and in the volume of trade do not in a period of great price changes accurately reflect fundamental economic conditions. For the volume of trade and of national wealth is computed in terms of money, which is depreciating in proportion to the rise of prices. A sample of the misleading conclusions drawn from statistics of trade expressed in terms of depreciated dollars is found in a recent statement in a prominent financial journal, commenting on export trade data furnished by a large New York bank. It was stated: "Exports from the United States to Germany in the fiscal year which ends with June, 1921, will exceed those of any year prior to the war . . . they will be of greater value, measured in good American dollars, than in any year in the history of our trade relations." This statement fails to take into consideration the great rise in prices that has occurred. If allowance is made for this fact, German purchases in the United States during the current year (1921) are less than any year as far back as 1900—before the so-called "American export invasion of Europe" began. When one of the greatest banks and one of the greatest financial journals in the United States will thus misread economic data, it is not surprising that the average layman is misled.

The absurdity of growing excited over figures of expanding national wealth at a time like this may be understood if one reflects that the wealth of Russia since the beginning of the war has, as measured in present Russian money, increased more than a thousandfold. Other countries differ from Russia only in degree.

Statistics which show the huge profits earned by industrial corporations are equally untrustworthy evidence of economic recovery. A period of monetary expansion and rising prices always means imposing paper profits, largely obtained through the process of buying goods at one price and selling them at an advance. In Austria goods frequently pass through the hands of fifteen or twenty speculative middlemen, each selling at a handsome advance above cost. The profits are thus the result of an inflation of values that carries with it no necessary increase in actual goods produced. In Germany, for example, the receiver of paper money dividends four times as large as pre-war gold dividends may at first glance appear to be prosperous; but his real poverty is revealed when he goes to purchase food, etc., at prices from ten to fifteen times the pre-war prices.

Improvements in agriculture and in food conditions are also cited as conclusive evidence that the worst of Europe's difficulties have now been compassed. Increasing agricultural production is essential to world recovery, it is true; but it is not the determining factor in world prosperity. As we shall see in the following chapters, the modern world is essentially an industrial world and on the recovery of industry hangs the rehabilitation of civilization.

Abatement of Social Unrest No Index

Furthermore the fact that social or industrial unrest is receding in this or that particular country at a given time, is by itself no conclusive evidence that economic recovery is

a thing assured. Unrest may be lulled into momentary inactivity by fantastic padding of government pay-rolls, by liberal payments of pensions and unemployment insurance, by subsidies, etc., as has been the case in nearly every country of Europe. It may be temporarily allayed by the drugs of monetary inflation, to which reference has already been made, as has clearly been the case in Germany. It may be held in leash by extravagant governmental promises of reparations, as has no doubt been the case in France. It may even give way to grim despair, as has been the case in Austria. Even where the recession of unrest may fairly be ascribed to a recovery from the neurasthenia of the war era, this factor by itself cannot insure prompt economic readjustment. The mere fact that the German or the Italian or the Belgian people may now be showing a renewed disposition to work, while a hopeful sign, by no means makes it certain that these people will be afforded an opportunity to work. There are millions of people in the United States today who are now willing to work, whose hands unfortunately find no work to do. The same condition exists in Europe.

How, then, can anyone judge whether Europe is on the highroad to economic recovery? What are the economic guide posts that reveal the true situation? If one is to understand the economic status of Europe at the present time, he must look beneath the transient surface phenomena, and read the lessons contained in the stories of: (1) the depreciation of the international exchanges; (2) the foreign trade statistics of the several European nations since the Armistice; (3) national debts and budgets; and (4) the reserves of banking systems. These are the true indexes of fundamental underlying conditions.

CHAPTER II

THE SIGNIFICANCE OF DEPRECIATED EXCHANGES

Misunderstood Problem

Foreign exchange, by means of which the trade of the world is conducted, is one of the least understood phenomena of commerce. This is not because the subject is inherently obscure or difficult, but only because in normal times the exchange mechanism works with such automatic precision that, save to a few special students or dealers in exchange, it appears to be of little significance. A great American merchant confessed to the authors that, although for years he had purchased large quantities of foreign goods and paid for them with bills of exchange, not until after war dislocated the exchanges had he ever taken the trouble to learn the principles determining exchange rates. Even now, after two years of disastrous experience with exchange gyrations, it is not an exaggeration to say that the mass of business men do not clearly understand the forces governing exchange fluctuations and the significance of the relative depreciation of the exchanges of different countries.

Witness the persistent purchasing and holding of German marks by thousands of speculators throughout the world—speculators who possess not the slightest knowledge of the forces that will ultimately determine the value of German exchange. Witness the astounding statement made recently by a well-known American business man that prior to the war European exchanges fluctuated as much as they do now. Witness the equally astounding statement of a French financier that the depreciation of French exchange is merely due to the speculation of American bankers.

The whole problem of international trade and world recuperation is intricately interwoven with the functioning of the foreign exchanges. If in our efforts to stem the tide of economic deterioration and restore world prosperity we are to grapple intelligently with the problems involved, we must begin with a fairly definite notion of what foreign exchanges are and what fundamental forces control them.

Exchange Explained

The conclusion to which an analysis of the foreign exchange mechanism leads is that the depreciation of the exchanges of the various European countries roughly reflects the economic deterioration of each. Now to understand why this is so it is necessary to consider not only what the exchanges are, but also what undepreciated exchanges mean and how in ordinary times before the war the exchanges were kept from depreciating. Only by so doing can one come to appreciate the enormous significance of the disruption of international trade and finance that was wrought by the war.

Exchange between the United States and Great Britain before the war, for example, was said to be at par when a one-pound British sterling bill was worth $4.866 in New York. What did par or parity of exchange mean, and how was this quotation, 4.866, derived? Parity of exchange was only a simple statement of the relative quantities of gold in the American gold dollar and in the British gold pound. The British monetary unit, the gold pound sterling, has 4.866 times as much gold as the American monetary unit, the dollar. To cite other exchanges, the par between the United States and France is 19.3, which means that the gold franc is worth 19.3 cents. Belgium, Italy, Switzerland, and Greece have coins of exactly the same value as the

French franc, and thus have the same parity with United States money. The German gold mark is worth 23.8 cents. The gold coin of each of the various countries thus has its particular parity as compared with United States gold, and in turn the gold pound sterling, franc, etc., each has its parity with the coins of all the other countries.

Bills of exchange largely obviate the necessity of shipping currency in settling international obligations. The use of bills of exchange in international transactions can best be revealed by some concrete illustrations.

Assume that you are a New York exporter and that you have sold £1,000 worth of shoes to one Perlmutter in London. At the same time your friend Jones in New York has bought £1,000 worth of lace from a well-known London lace merchant, one Potash. If you could then step over to your friend Jones's office and receive payment of £1,000 from him, while at the same time Perlmutter in London was paying Potash £1,000, both obligations would be settled. How much easier this would be than for Perlmutter to ship £1,000 in specie across the ocean westward to you, and for friend Jones to ship another £1,000 in specie across the ocean eastward to Potash.

The exchange mechanism, in fact, makes it possible to settle such international obligations without shipping specie every time. If you in New York were to draw an order (bill of exchange) on Potash in London, instructing him to pay Perlmutter £1,000; and then sold this bill of exchange to your friend Jones, you would receive payment for your shoes. Then if Jones should send this bill of exchange, which he had purchased from you, to Potash in payment for the lace, Potash would be satisfied as soon as he had collected from Perlmutter. Thus the shoes and the lace would be paid for without any necessity for shipment of specie across the ocean.

Foreign Exchange Banker

But in practice there are usually two difficulties which slightly complicate the process. In the first place, the various parties concerned may not all be acquainted with each other. Secondly, the amounts involved in the two transactions may not be identical, as was supposed above. Accordingly, dealers in foreign exchange (banks and brokers) are required as financial intermediaries. When the exporter in New York draws his bill of exchange for £1,000 on the importer in London—or more frequently on a London bank which has agreed to lend its name to the importer for the purpose—the exporter in New York sells the bill to a foreign exchange banker in New York who will pay, when exchange is at par, $4,866. This banker then sends the bill to a correspondent bank in London which presents it for payment to the London importer, or to his bank. The funds received are deposited in the London bank to the credit of the New York bank which had forwarded the bill for collection.

Now when your friend Jones in New York wants to buy a bill of exchange with which to pay for the lace bought from Potash, he goes to the foreign exchange banker in New York, and the banker sells him a bill of exchange drawn by it against this London bank account—a bill for £1,000 or for whatever amount the buyer may desire. Jones then sends this bill of exchange to Potash, in London, who presents it for payment to the bank against which it is drawn.

In this manner the New York banker plays the part of an intermediary between New York exporters and importers, serving in effect to bring them together, and serving also to make "change," that is, to break up bills of exchange into whatever denominations may be found necessary.

Rate Fluctuations

Exchange will be at par when the supply of and the demand for bills of exchange are equal. The price of a bill of exchange, like the price of wheat or any other commodity, depends upon the relative demand for and supply of bills in the market at the moment. If at any given time £1,000,000 worth of American products have been exported to Great Britain, there will be £1,000,000 worth of bills on London offered for sale in New York. If at the same time £1,000,000 worth of goods have been imported, there will be a demand for £1,000,000 of bills of exchange. The supply and demand will be equal and the price of sterling exchange will be at par, that is, at 4.866. But if it happens that while £1,000,000 worth of bills is offered in the market for sale, as much as £1,200,000 is demanded, the price will be bid up above 4.866 by those who desire the bills as a means of meeting their obligations abroad. On the contrary, if only £500,000 is demanded, the sellers will have to make concessions in order to dispose of their bills.

Exchange rates before the war normally fluctuated within narrow limits. The maximum extent to which (under normal pre-war conditions) the price of exchange could be bid up or forced down, as the case might be, was determined by the costs involved in shipping the actual gold. One would be willing to pay $4,866 for a bill of exchange with which to settle a £1,000 obligation, because that would be cheaper than shipping the gold. One would be willing to pay as high as $4,885, under normal conditions, for such a bill; but not more than that because it would be cheaper to ship the actual specie instead. On the other hand, it would be profitable to sell a £1,000 bill for $4,845; but not for less, since it would be cheaper to pay the expense of importing the actual currency. These points, 4.885 and 4.845, are known as gold-exporting and gold-importing points.

The International Scale-Pans

The supply of and demand for bills of exchange do not depend merely upon the relative volume of exports and imports of commodities. Whatever the occasion for remittances of funds to Great Britain, bills of exchange are demanded, and whatever the occasion for payments to the United States, bills of exchange are supplied. For instance, if an individual is contemplating a trip abroad he places, say, $4,886 with a bank, express company, or one of the tourist concerns, and asks for letters of credit or travelers' checks. It then becomes necessary for the bank where the funds have been deposited, to transmit means of payment to the other side. This it does by buying a bill of exchange which it sends to a correspondent bank in Europe, where it is credited to the account of the American bank, and made available for the payment of checks when properly signed by the authorized party. Similarly, if an American corporation owes dividends to a stockholder in England, it buys and remits a bill of exchange.

The operations which give rise to the total supply of and demand for bills of exchange may be shown by an exhibit of the international financial status of the United States in a single year before the war. The following figures are for the year 1909. The items listed in the left-hand column give rise to a supply of bills of exchange and those in the right-hand column to a demand for such bills.

Requiring Payments to United States		Requiring Payments Abroad	
Exports of merchandise and silver	$1,719,000,000	Imports of merchandise and silver	$1,356,000,000
Exports of gold (net)	48,000,000	Interest on European investments in U. S.	250,000,000
Total	$1,767,000,000	Tourist expenditures	170,000,000
Balance against United States	184,000,000	Remittances to friends	150,000,000
		Freight charges	25,000,000
Grand Total	$1,951,000,000		$1,951,000,000

It should be carefully noted that our exports abroad were largely paid for by imports of foreign goods. No gold was received in payment; on the contrary, we exported on balance $48,000,000 of the precious metal. The difference in the trade balance (between exports and imports of merchandise and silver) amounting to $363,000,000, plus the $48,000,000 of gold exports, was more than offset by other items in the international scale-pans. We owed interest on European investments in the United States; our tourists were entertained in Europe; immigrants and others sent funds to friends abroad; and we owed foreign ship-owners for transporting our goods. The final outcome of all these operations showed a balance of $184,000,000 still to be accounted for. This might have been settled by an exportation of gold; but it was in fact offset by new—permanent or temporary—investments in the United States by other countries.

Gold Movements

The United States will thus have, in any given year, a net inflow or net outflow of gold as a result of variations in the supply of and demand for bills of exchange arising from trade and financial operations with all the world. The simplified treatment which we have presented ignores such factors as "finance," as distinguished from "trade" bills. Nor is mention made of roundabout operations involving several countries. These three-cornered operations play an important part in minimizing the flow of specie in the settlement of international obligations. But the essence of the problem is revealed in the analysis stated above.

The mechanism of the exchanges makes it unnecessary for any country to ship specie except when the total of all foreign financial obligations that must be met is greater than

the volume of remittances of every kind due it. International obligations are thus largely canceled; currency moves only as a last resort. Foreign exchange quotations, moreover, in ordinary times, fluctuate only from the gold-exporting to the gold-importing point, that is to say, in terms of British currency, from 4.885 to 4.845.

Currency movements maintain the equilibrium of the exchanges. Under normal circumstances it is impossible for an outflow of specie from any country (except, of course, from a gold-producing country) to continue for any great length of time. The reason for this is that such an outflow is soon followed by financial and trade readjustments, which shortly restore the balance of international obligations. An outflow of gold from the United States to England, for example, would reduce the volume of funds in New York, and lead to higher interest rates there. The inflow of funds to the London banks would at the same time tend to lower interest rates in England. In consequence, international bankers would find it profitable to transmit, by means of bills of exchange, funds from London to New York. This would serve to restore the equilibrium of the exchanges and to prevent a further outflow of gold from New York, if not to bring about a reverse movement.

Variations in exchange rates above or below parity thus reflect temporary fluctuations in the supply of and demand for bills of exchange arising from international financial transactions of whatever nature. And gold movements serve as the corrective for any pronounced excess or deficiency in the supply of, as compared with the demand for, bills of exchange in any particular country. In this manner the gold movements act as a balance wheel in international economic relations, keeping the world in economic adjustment.

Disruption of Exchange Mechanism

The World War quickly threw this delicately adjusted foreign exchange mechanism completely out of gear. In the autumn of 1914 there was a great rush on the part of European holders of American securities to sell them back to us as a means of securing the funds required for war purposes. At the same time the usual autumn exports of our cotton and other products were checked, both by a temporary decline in European demand and by the fear of German raiders. Insurance rates also tremendously increased, so that the gold-exporting point no longer remained at 4.885. So great was the demand for sterling bills as compared with the supply, that British exchange rose at one time as high as $7.

But in the autumn of 1915 the situation was sharply reversed. When Great Britain began to buy great quantities of war supplies from the United States, the supply of sterling bills of exchange outran the demand, and exchange quickly fell to the gold-importing point. For a time Great Britain attempted to use the normal method of correcting adverse exchanges, namely, by allowing an export of gold; but this had shortly to be abandoned because of the disastrous consequence to the British monetary system of continued large exports of specie. An embargo was therefore placed upon exports of specie, except as government operations might require it. What was true of Great Britain was of course also true of other European belligerents.

The balance of payments continued to run so heavily in favor of the United States that sterling declined to 4.48—far below the gold-importing point. With the normal means of correcting depreciated exchanges—that is, by payments in gold—perforce abandoned, exchange rates, under the pressure of a great volume of exports, could fall almost indefinitely. During the war, however, the British and

other European governments undertook and successfully accomplished an artificial stabilization of exchange rates—the sterling rate being "pegged" at 4.765. This was done through purchase of exchange by the British government whenever the rate dropped below that figure. At the same time the United States government began the war-time policy of shipping American goods abroad on credit. Such a method of regulating the exchanges could not be continued as a permanent policy after the war.

Sharp Decline of Rates

In order to restore the normal functioning of the international exchanges, the various European governments in the spring of 1919 abandoned the artificial policy of "pegging" the exchanges, and shortly thereafter the United States government ceased making further loans to Europe. But for reasons to be discussed presently, Europe did not remove the embargoes on gold shipments; hence the normal corrective of depreciated exchanges could not operate. The results of the international economic maladjustments caused by the war were quickly shown in a sharp fall in exchange rates on all of the European belligerents.

What students of the international exchange mechanism had long foreseen must occur, now for the first time manifested itself to the general public. In the summer of 1919 the financial press daily discussed the sensational decline in foreign exchange; and business men, with a practical interest in foreign trade, began for the first time in our national history to interest themselves in the phenomenon of the exchanges. And thousands of innocent bystanders, acting on the familiar principle that what goes down must soon go up again, speculated heavily in francs, marks, and kronen. They are still pocketing their losses.

The explanation of the present depreciated European

exchanges is in reality twofold: It is due in part to the tremendous changes that have occurred in the financial and trade relations between the United States and the several European countries—changes which have transformed the United States from a debtor to a creditor nation. And it is in part attributable to the fact that all of the European nations have been forced to abandon the gold standard for irredeemable paper money. These factors must be considered separately.

International Scale-Pans Unbalanced

The changes that have occurred in the international financial relationships of the United States, as a result of the war, may be best shown by setting off against the items entering into the international balance in 1909, the items entering into it in 1919.[1] The figures for 1909 are the same as were presented on page 13 above. For convenience they are repeated here.

FIGURES FOR 1909

REQUIRING PAYMENTS TO UNITED STATES		REQUIRING PAYMENTS ABROAD	
Exports of merchandise and silver	$1,719,000,000	Imports of merchandise and silver	$1,356,000,000
Exports of gold (net)	48,000,000	Interest on European investments in U. S.	250,000,000
		Tourist expenditures	170,000,000
		Remittances to friends	150,000,000
		Freight charges due Europe	25,000,000
Total	$1,767,000,000		$1,951,000,000

Balance against United States $184,000,000

[1] These figures are taken from Vanderlip and Williams, "The Future of Our Foreign Trade," an article prepared for *The Review of Economic Statistics,* Harvard University Committee on Economic Research. The year 1920 still further increased the disparity, although the excess of exports was not so large as in 1919.

FIGURES FOR 1919

REQUIRING PAYMENTS TO UNITED STATES		REQUIRING PAYMENTS ABROAD	
Exports of merchandise and silver	$8,151,000,000	Imports of merchandise and silver	$3,993,000,000
Exports of gold (net)	368,000,000	Tourists expenditures	50,000,000
Interest on American investments in Europe	[2]122,000,000 500,000,000	Remittances to friends	300,000,000
Freight charges due U.S.	73,000,000	Total	$4,343,000,000
		Balance in favor of United States	$4,771,000,000
	$9,114,000,000		$9,114,000,000

Changes in Trade Balance Items

It will be seen that nearly every item entering into the international balance has been changed during the war in such fashion as to increase the supply of, and reduce the demand for, bills of exchange on foreign countries. The great increase in exports as compared with the increase in imports would alone have congested the exchange market and forced a decline in the price of bills of exchange. But in addition, the United States has become a creditor nation, with the result that the $250,000,000 interest formerly payable by us to Europe has been wiped out and replaced by an annual interest charge against Europe of $622,000,000.[3] Europe can therefore no longer use interest due as an offset to the excess of imports; she must rather find means

[2] The $122,000,000 represents the estimated interest on private investments and credits abroad; the $500,000,000 is 5 per cent on the $10,000,000,000 loaned by the United States government to European governments. Payment of this is being indefinitely postponed, the annual interest charges thus being added to the principal. It has been computed that by 1923 the accumulated amount will stand at $12,350,000,000, the interest charge on which would equal at 5 per cent, $617,000,000 annually. In addition to these debts owing to the American government, foreign governments owe to private individuals in the United States approximately $2,000,000,000. (Financial report of the American Committee to International Chamber of Commerce meeting in London, June 26, 1921.)

[3] As a result of further credit extensions since 1919, this figure is now considerably larger.

of meeting huge interest charges due against her.[4] Tourist expenditures in Europe have also been reduced.[5] And freight charges due Europe have been replaced by freight charges due to the United States. Only a single item in the balance has changed to the advantage of Europe, namely, the increase in remittances to friends abroad. It should be noted, moreover, that the export of gold was much larger in 1919 than in 1909. All but one of the elements entering into the international scales, therefore, worked to bring about a fall in exchange rates—through increasing the supply relatively to the demand for bills of exchange.

It remains to be noted that the international scale-pans for the year 1919 were balanced through the extension of American investments abroad. This was accomplished partly by the sale in the United States of European securities; but much more largely by the sale of goods by American exporters on credit. That is to say, exporters shipped goods abroad and received not cash, but promises to pay at some not distant date in the future. Necessary renewals of these credits have, however, made them in the nature of long-term rather than short-term credit extensions. Meanwhile the exporters have borrowed funds with which to carry such export credits largely from the commercial banks.

Depreciated Paper Currency

The second factor instrumental in the depreciation of the exchanges, namely, the abandonment of the gold monetary standard in Europe, while not so generally understood, is even more easily explained. We have already seen that the

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[4] This interest is, however, temporarily being funded. See footnote 3.

[5] The years 1920 and 1921 have, however, shown considerable increase in this connection.

normal parity of exchange is an expression of the comparative quantities of gold in the American and foreign monetary units. At the present time, however, the parity of exchange between the United States and Great Britain is not 4.866, for the reason that American money which is redeemable in gold and is therefore the equivalent of gold, is exchangeable only for British paper money, which is not redeemable in gold and is therefore not the equivalent of gold. Since all of the European countries now have irredeemable paper money, the parity of exchange between American gold and European paper currency is in no case the same as the former parity between American gold and the gold of the several European countries. In fact, strictly speaking, there is no longer any parity.

Since British paper money has depreciated about 20 per cent in comparison with British gold, American traders and financiers are now unwilling to exchange $4.866 in American gold for £1 in British paper money.

Foreign exchanges have fallen to the extent that the domestic paper currency of European countries is now worth less than gold. With reference to Great Britain this is a factor that is probably secondary in importance to the maladjustment in trade and financial transactions, since the British paper currency is not very greatly depreciated. But with reference to the continental countries, particularly those east of the Rhine, depreciation of the paper currency is the principal cause of falling exchanges.

The truth of this last contention may be seen from the fact that while the trade and financial relations between the United States and the central European countries have been far less unbalanced than between, for example, the United States and England, the depreciation of the exchanges, as will be seen from the table below, is far greater in the central European countries.

Exchange Depreciation

The following table gives the pre-war normal parities between the United States and the principal European countries, the rates one year ago, and the present quotations:

		Par		Aug. 3, 1921		Aug. 3, 1920	
Great Britain	(sterling)	$ 4.866		$ 3.56		$ 3.64	
France	(franc)	19.3	cents	7.62	cents	7.35	cents
Italy	(lira)	19.3	"	4.22	"	5.20	"
Belgium	(franc)	19.3	"	7.32	"	8.07	"
Germany	(mark)	23.8	"	1.22	"	2.20	"
Austria	(krone)	20.3	"	.12	"	1.60	"
Roumania	(leu)	19.3	"	1.25	"	2.56	"
Czechoslovakia	(krone)	20.3	"	1.25	"	2.00	"
Poland	(mark)	23.8	"	.05	"	.60	"
Jugoslavia	(krone)	20.3	"	.56	"	1.35	"
Denmark	(krone)	26.8	"	15.18	"	15.60	"
Finland	(mark)	19.3	"	1.55	"	3.95	"
Holland	(guilder)	40.2	"	30.50	"	33.10	"
Sweden	(krona)	26.8	"	20.33	"	21.15	"
Norway	(krone)	26.8	"	12.66	"	15.70	"
Switzerland	(franc)	19.3	"	16.40	"	16.95	"
Spain	(peseta)	19.3	"	12.75	"	15.25	"

The extent of the depreciation of the exchanges mirrors in a rough way the degree of general impoverishment and economic retrogression in each European country. And the relative depreciation from par of the exchanges of the different countries reflects pretty accurately the varying degrees of economic deterioration in the several European countries. Classified in broad groups, it will be seen that the exchanges of the neutral nations are the least depreciated; those of the Allied belligerents next; and those of the central and eastern European nations most of all.

During the past year (1921) the exchanges on every European country, except France, [6] have declined. Those

[6] The reasons why French exchange has been held up relatively to the others is discussed on page 91. It is not, however, indicative of genuine improvement in French conditions.

on the countries of central and eastern Europe have declined very heavily; those of the neutral countries considerably; and those of the Allied nations, France excepted, somewhat. One must therefore conclude that on the whole the foreign exchanges indicate a European situation somewhat worse this year than last.

Many persons have been misled during the first half of 1921 by rising exchanges that were merely attributable to seasonal influences. The rates of the winter and spring every year are substantially higher than those of the summer and autumn. This is mainly because it is during the summer and fall that our exports are largest. The significant thing to note, therefore, is that, speaking generally, the rates this year have been below those of last year at each season of the year. The upward movement did not go as high as last year, and the downswing is therefore more pronounced than in 1920.

Effects of Depreciated Exchanges—1. Risks of Trade

The depreciated exchanges, while reflecting the economic decadence of European nations as compared with the United States, at the same time also act as a deterrent to European economic recovery. There are two ways in which the instability of the exchanges impedes foreign trade and the economic rehabilitation of Europe. First, it greatly increases the risk of trading operations and thus operates as a damper to business enterprise. The exchanges fluctuate widely from month to month, due (1) to speculative buying or selling of exchange in anticipation of improving or worsening conditions in Europe; (2) to changes in the volume of trade and other international transactions; and (3) to fluctuations in the value of the irredeemable paper currency of the various European countries.

Since all modern business is organized on a profit-making

basis, it is of the utmost importance that business men be able to calculate their chances of profit with a reasonable degree of certainty. But fluctuating exchange rates mean great uncertainty as to the value of the money ultimately received in payment for a shipment of goods. Contracts entered into on the basis of the exchange quotations of January 1, are settled on the basis of exchange quotations some months later, with resulting uncertainty for both parties to the transaction. The greater and more unpredictable the fluctuations in exchange rates, the greater the hesitancy to undertake the fulfilment of time obligations.

2. Curtailment of American Exports

The second way in which depreciated exchanges impede the economic recovery of Europe is through increasing the cost of goods purchased in the United States and other countries whose exchange rates are relatively high. For example, when French exchange is quoted at 6.40, it is worth only about one-third of its normal value of 19.3. This means that a French importer has to pay 19.3 cents for every 6.4 cents worth of goods received, or $3 for every $1 worth of goods bought in the United States. This would not matter if prices in France were higher than those in the United States in precise proportion to the depreciation of French exchange, that is to say, if the $1 worth of goods bought in the United States could be sold in France for $3, plus profit. But such is not precisely the case. When, for example, at the worst French exchange was worth only about one-third its normal parity, French prices were only about double American prices.

It should be observed, moreover, that since French exchange is less depreciated as compared with British than with American money, it pays France to import from Great Britain rather than from the United States, whenever it is

possible to obtain the required goods there; and inasmuch as German exchange is greatly depreciated even as compared with the franc, France can buy still more cheaply in Germany. Since America is the dearest market in the world, purchases have to be confined to the minimum.

While this situation thus threatens our export trade, it could not seriously impede the recovery of Europe were it not for the fact that European countries are in so large a degree dependent upon American imports. Since the Armistice they have in fact been buying huge quantities of American goods on credit, but at a very heavy cost to themselves. As we shall presently see, European nations have been going ever more deeply into debt, without having effected any substantial recovery from the effects of the war. And not the least unfortunate aspect of this increasing indebtedness is the fact that so considerable a portion of it was contracted in the purchase of non-essential commodities during the period of the post-war luxury debauch. In view of the psychological effects of the war it was perhaps inevitable that we should pass through such a period. Be this as it may, the consequence has been that Europe still stands in great need of purchasing certain kinds of materials from the United States. But Europe is on the whole less able to make these purchases now than it was at the time of the Armistice. The truth of this statement will be more fully revealed in subsequent chapters.

CHAPTER III

IS EUROPEAN TRADE RECOVERING?

Favorable Trade Balance Necessary

The enormous disruption of the trade of Europe during the war was roughly portrayed in the discussion of the foreign exchanges in the preceding chapter. Exports were curtailed and imports were tremendously increased, with resulting huge adverse trade balances. Early in the war—it bears repeating—the excess of imports was paid for partly in gold and partly by the resale to the United States of European investments in this country. When these resources were exhausted Europe borrowed from the United States, that is to say, we shipped the goods abroad on credit, European governments agreeing to pay for the goods at some future date, after the war was over. Meanwhile the United States government paid the exporters with funds raised from the sale of Liberty bonds. At the time of the Armistice these government credits abroad amounted to nearly $9,000,000,000. They have since been increased to about ten billions; while private credits amount to three or four billions more. The United States has thus become a huge creditor nation.

Now if Europe is to retrace her steps, to restore her trade and recover her financial equilibrium, she must gradually reduce [1] imports and expand exports. An individual gets out of debt by paying his debts; and it is the same with a nation. But a nation cannot pay large debts by shipping money. As the analysis of the international exchanges in the preceding chapter indicates, nations must meet their

[1] If not actually reduce imports, at least expand exports until they greatly exceed imports.

obligations abroad with either goods or services—usually the former. Hence the necessity for Europe to expand exports.

But it may be argued that it is unnecessary for Europe to wipe out the debt completely. May she not remain permanently indebted to the United States, permanently paying interest on borrowed funds? True, but at least Europe must sooner or later cease to go further into debt; and if she is to regain financial solvency she must place herself in a position where she can at least pay interest on the debt which is owed. This can be accomplished only by securing a large favorable balance of trade. No other way of re-establishing economic equilibrium has ever been invented.

As matters now stand it would require between Europe and the United States an excess of exports over imports of about $700,000,000 annually to meet interest charges alone. And if we assume that the debt, amounting to approximately $14,000,000,000, is to be paid off in forty years, another $300,000,000 of exports would be required annually for sinking funds.

Slow Progress Made

Let us now enquire what progress Europe has been making toward securing this necessary favorable balance of trade. It was, of course, not to be expected that much, if anything, would be accomplished in the first year following the end of the war. The prolongation of the peace negotiations, the difficult and tedious task of demobilization, and the economic prostration caused by the war, combined to render immediate progress impossible. It was inevitable, indeed, that Europe should plunge still further into debt, in order to procure the raw materials necessary for reconstruction. Until European industries should be restored and the several nations placed upon their economic feet, so to speak, it was of course idle to look for a return to a favorable trade position.

But nearly three years having passed since the conclusion of the Armistice agreement, it would seem that sufficient time has elapsed to show results. But even now little progress is to be recorded. In view of the widespread impression that Europe has been making remarkable progress toward economic rehabilitation, the following tables which show the trade of Europe as a whole with the United States are significant. The first table shows the trade since the beginning of 1920 by quarters.

European Trade with the United States

(000,000 omitted)

1920	Exports to U. S.	Imports from U. S.	Balance against Europe
1st quarter	$344	$1,319	$975
2nd "	322	1,044	722
3rd "	325	948	623
4th "	237	1,070	833
1921			
1st quarter	191	767	576
2nd "	185	529	344

The following figures show the monthly trend since last autumn:

(000,000 omitted)

1920	Exports to U. S.	Imports from U. S.	Balance against Europe
November	$82	$357	$275
December	67	389	322
1921			
January	60	327	267
February	55	243	188
March	77	199	122
April	69	174	105
May	61	177	116
June	55	178	123

If one studies only the final column in these tables he may conclude that Europe is making genuine progress toward trade recovery. Has not the adverse trade balance been materially reduced since last autumn? This is in fact the conclusion that has commonly been drawn from these foreign trade statistics.

But if one gives heed to the other columns as well, he will find the explanation of the decrease in the adverse trade balance of Europe, not in a great increase in exports and a decrease in imports, but in a great decrease in imports [2]—exports declining also, though less rapidly. Attending this great reduction in imports from the United States is a corresponding decrease in production in Europe. And—after a brief lag—this results, among other things, in a further reduction of European exports. It should require no extensive analysis to show that if Europe cannot purchase American cotton and other raw materials, she cannot hope to maintain the volume of her exports of finished commodities. Only in slight degree is the decline in European imports attributable to the elimination of purchases of luxuries and non-essentials. The reduction is common to practically all lines; and is attributable to the business depression and the gradual exhaustion of European purchasing power.

British Foreign Trade

The above figures, however, relate only to the trade between Europe and the United States. Is it not possible that there has merely been a shifting of trade? That American loss has been the gain of other nations? Statistics of the foreign trade of leading European nations with the world

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[2] Some allowance must be made in these aggregate figures for the fluctuations in prices that have occurred. That the decline in recent months is not mainly attributable to the mere decline in prices is, however, evident from the fact that the decline in trade has been rapid since the rate of price decline began to slow down.

as a whole will serve at once to answer this question and to reveal the precise trade situation of particular countries.

The table which follows shows the trend of British trade since June, 1918:

GREAT BRITAIN'S FOREIGN TRADE

(£000,000 omitted)

1918	Exports	Imports	Adverse Balance
3rd quarter	£127	£317	£190
4th "	124	350	226
1919			
1st quarter	147	347	200
2nd "	187	370	183
3rd "	206	450	244
4th "	257	467	210
1920			
1st quarter	295	530	235
2nd "	342	503	161
3rd "	370	468	98
4th "	328	437	109
1921			
1st quarter	228	398	170
2nd "	141	264	123

The following are the monthly figures for British trade since the autumn of 1920:

(£000,000 omitted)

1920	Exports	Imports	Adverse Balance
November	£119	£144	£25
December	97	143	46
1921			
January	93	117	24
February	68	97	29
March	67	94	27
April	60	90	30
May	43	86	43
June	38	88	50
July	43	81	38
August	51	89	38

The figures of adverse balance (in the final column) are here also less significant than the trends disclosed in the other columns. During 1919 and the first months of 1920, both exports and imports increased. While British students recognized that the imports remained disappointingly large, much satisfaction was derived from the steady increase in exports. Great Britain appeared to be headed in the right direction. But in the summer of 1920 the tide turned; both exports and imports began to decline. The persistency with which the progressive decline has been maintained is shown by the monthly figures since last November. The decline began long before the coal strike. It is at bottom a reflection of the world-wide depression, although the May and June figures, of course, reveal the additional disastrous consequences of the cessation of coal mining. The bottom was probably reached in June; but there is little reason to believe that the figures for the ensuing months will greatly exceed those of April.

In May, 1914, British exports were £42,000,000 and imports £52,000,000, leaving an adverse balance of only £10,000,000. Since the present British price level is almost exactly twice that of 1914, it will be seen that the present *physical* volume of exports is only about half what it was in May, 1914, while the present physical volume of imports is nearly equal to that before the war. The exports for May are, moreover, scarcely equal to those of the spring of 1918, when the war strain was at its height.

French Foreign Trade

The facts as to the foreign trade of France are particularly interesting, since they have been so frequently cited of late as conclusive evidence that France is rapidly recovering her foreign trade position. The following figures taken from the Federal Reserve Bulletin, are expressed in 1919 value

units; hence the fluctuations revealed are those which took place in the physical quantities:

(In francs, 000 omitted)

	Exports	Imports	Adverse Balance
1919, monthly average	989,966	2,983,272	1,993,306
1920, " "	1,869,563	2,950,413	1,080,850
1920			
August	2,399,508	2,800,453	400,945
September	2,151,573	2,627,876	476,303
October	2,332,552	2,595,445	262,893
November	1,883,598	2,672,178	788,580
December	1,660,896	2,948,257	1,287,361
1921			
January	1,882,618	1,982,468	99,850
February	1,899,444	1,613,931	*285,513
March	1,686,426	1,742,908	56,482
April	1,932,268	1,779,089	*153,179
May	1,648,635	1,565,508	*83,127
June	1,950,464	1,723,534	*246,930
July	1,563,065	1,469,117	*94,948
August	1,726,092	1,731,294	5,202

* Favorable balance.

It will be seen from the last column that the "great improvement" came at the beginning of 1921. It is these figures of the French trade balance that have been so widely circulated as conclusive evidence of French recovery. Let us see how much significance is to be attached to them.

Reference to the imports and exports columns reveals that the big change in trade balance that occurred in January was wholly due to a collapse of imports—from 2,948,257,000 in December, to 1,982,468,000 in January. In that month exports also fell somewhat. For the first six months of 1921 imports have been only a little more than half what they were last summer and autumn. While exports have held up remarkably well, as compared with those of

Great Britain, they have nevertheless fallen; in August, 1921, they were only about 75 per cent of what they were in August, 1920. Do these figures then prove that France is coming back with giant strides, as has been contended even by eminent financiers and statesmen?

The collapse of imports might, conceivably, indicate that French purchasing power and French credit have been proportionately reduced. If this is the case, French exports will shortly show material further declines. The substantial maintenance of French exports during recent months might at the same time be explained by the familiar "lag"; the large volume of raw materials imported in the autumn would naturally not be ready for export as finished goods until some months later. The detailed figures of French imports, in fact, show that the increase of total imports during the late autumn of 1920, as compared with August, was due to increased buying of raw materials; imports of food and manufactured articles both declining.

Other factors helping to maintain the volume of French exports to date are the exportation of German coal, furnished under the Spa agreement, to fill the gap caused by the British coal strike, and export back to the United States of American war supplies "sold cheap" on credit to France after the Armistice. Neither of these, of course, bespeak increasing production in France.

Character of French Imports

The only reasoning that could lead to the conclusion that the present trade figures of France indicate an improving economic situation is that the decline in imports represents a curtailment of foreign purchasing of luxuries, on the one hand, and of foodstuffs, on the other. Do the detailed figures show that this has been the case? The data for August and December, 1920, and for June, 1921, follow:

Character of French Imports

(In francs, 000 omitted)

	Food	Raw Materials	Manufactured Materials	Total
1920, August	723,749	1,171,091	905,613	2,800,453
1920, Dec.	672,861	1,548,681	726,715	2,948,257
1921, August	555,545	855,697	320,052	1,731,294
Decline per cent since Aug., 1920 .	23	27	65	38

The largest percentage decrease in imports is in manufactured articles, which include luxuries. This evidences curtailed consumption. The next largest decrease is in raw materials, indicating that purchases of basic essentials for manufacturing have been falling. The dearth of raw materials is, however, not being made good by increased production, as the declining exports witness.

Importations of foodstuffs were 23 per cent less in August, 1921, than in August, 1920, and 18 per cent less than in December, 1920. This indicates some genuine improvement in French agricultural conditions. Agriculture is not directly affected by business depression, and a decrease in imports of foodstuffs, in the main, indicates increased domestic production of foodstuffs. In the year 1920 agricultural production increased considerably as compared with the year previous. Further improvement would no doubt have been shown this year had it not been for the unprecedented drought. As it stands, however, agricultural production in France will probably be smaller than it was last year, with the result that food imports for the second half of 1921 will not be much less than they were a year ago. The fact that the Hoover Relief Organization has had to resume operations in the devastated areas this summer is significant.

The conclusion with reference to French foreign trade, therefore, is that the data which have been so widely quoted

as proof of remarkable improvement in France prove nothing of the kind. There has seldom been a more egregious error in the interpretation of economic data than that which finds in recent French trade figures evidences of remarkable improvement in French conditions. The collapse of French imports, which alone accounts for the "favorable" trade balance, is apparently due in part to the curtailment of American export credits; but it is in the main a reflection of the world-wide business depression. All that can be said is that French exports have held up surprisingly well as compared with those of other nations.

Italian Foreign Trade

The following data show the present foreign trade position of Italy:

(In lire 000,000 omitted)

	Exports	Imports	Adverse Balance
1919, monthly average	506	1,385	879
1920, " "	650	1,322	672
1920			
August	532	1,249	717
September	570	1,202	632
October	707	1,126	419
November	731	1,240	509
December	853	1,591	738
1921			
January	503	1,166	663
February	566	1,320	754
March	569	1,503	934
April	586	1,346	760
May	453	1,191	738

It should be noted first that Italian exports this year are only a little larger than in 1919, and that they are now running considerably less than the average for 1920. More-

over, they have fallen very materially since the peak was reached last autumn. This in spite of the fact that the process of inflation has not been so definitely checked in Italy as in France.

The second point to be observed is that the Italian trade balance has not, like that of France, improved in recent months. This is because the imports have not as yet shown any tendency to decline, doubtless because of the persistence of inflation in Italy, the data on which will be presented in Chapter IV.

Swedish Foreign Trade

The following trade data for Sweden may be taken as typical of those for the neutral countries of Europe. All figures are computed on the basis of 1919 value units.

(In kronor, 000,000 omitted)

	Exports	Imports	Adverse Balance
1919, monthly average	131	211	80
1920, " "	191	281	90
1920			
August	230	308	78
September	233	325	92
October	218	299	81
November	177	228	51
December	171	197	26
1921			
January	91	122	31
February	89	116	27
March	75	99	24
April	69	106	37
May	82	95	13

The balance has been reduced somewhat, but only because the imports have fallen a bit more than the exports. The significant thing is that Swedish trade in general is

stagnant. The neutral countries generally have suffered quite as much from the world-wide depression as have the belligerent nations.

Discussion of German foreign trade is reserved for the chapter on Germany's ability to pay. It only remains to state that the trade of the other former Central Powers has suffered greatly this year, as has also that of Russia, Poland, and the other states created by the peace settlement.

The conclusion of the chapter is, clearly enough, that European trade this year has, on the whole, been very much less satisfactory than it was in 1920. According to the foreign trade index, Europe is not as yet coming back; on the contrary, the real economic aftermath of the war is now making itself felt.

CHAPTER IV

NATIONAL DEBTS

Past Fiscal Policies

Like Dickens' genial Micawber, who optimistically presented his I.O.U.'s in fancied "settlement" of his steadily mounting obligations, a very considerable percentage of the human race is strangely oblivious of the inevitable consequences of unrestricted debt accumulation. No matter how great or how pressing the obligations, there is always an abiding faith that something is sure to "turn up" which will afford a breathing spell and provide an opportunity for making the necessary preparation for an adjustment of one's financial relations. And in the case of government debts there is far greater indifference to consequences than with private obligations. It is hardly too much to say that the great majority of people assume, instinctively as it were, that a rapid growth of government debts is a matter of little moment. When obligations fall due, renew them; then go right on accumulating more.

One of the hardest lessons society has ever had to learn is that government revenues must be made to equal government expenditures if ultimate financial disaster is to be avoided. The lesson, however, appears to have been fairly well learned, except in Mexico and numerous countries of Central and South America, by the end of the nineteenth century. All of the leading national governments of the world, and most state and municipal governments, raised revenues sufficient to meet expenditures. While accumulated debts were seldom reduced, they were nevertheless under control; they were not allowed to increase regardless of the

adequacy of revenues for the payment of interest thereon. Financiers and economists were reasonably content with this feature of government fiscal management.

When Alexander Hamilton assumed control of the finances of the Republic in 1789, he found it necessary to reckon with the fact that one of the chief causes of the American Revolution had been the insistence of colonial governments on their inalienable rights to issue bills of credit and acquire debts without consent of the mother country. He also found that the strongest opposition to the adoption of our federal Constitution came from those colonies which had experimented most with the government printing presses. They strongly opposed giving to the federal government the power to coin money and regulate the value thereof. And many years later, in the fourteen years following the Civil War, a struggle took place to determine whether the United States government should be allowed to issue United States notes or greenbacks as a means of getting something for nothing. However, in the years immediately preceding the Great War, unsound government financial methods had given way before the accumulated wisdom derived from the disastrous experiences of the past.

Lessons Unlearned

The war has, however, turned backward the clock of time. Society appears to have unlearned the lessons it was believed to have mastered. With barely an exception, European governments have made no real effort since the war to adjust expenditures to income; and there has been an amazing popular indifference to this appalling fact. It is, moreover, not merely national governments that have fallen into evil ways; European states and municipalities without number have followed a similar course. And Europe is not

alone in pursuit of this folly, as anyone may see who will take the trouble to scrutinize the financial status of New York and Chicago, the two largest cities in the United States.

It is not merely because it is extremely difficult to balance budgets that governments fail to do so. It is almost as much because the lessons of sound finance have been forgotten. Interestingly enough, it is not the uneducated classes alone who are responsible for the present disregard of correct principles of government finance. An amazing number of prominent government officials and men of affairs were swept off their feet by the events of the war. At the time of the Armistice there was no end of prediction in Washington and London and Paris that there was no possibility of a post-war era of depression and hard times, because society had learned how to make effective use of that marvelous economic phenomenon known as credit. The staggering volume of credit operations during the war had, in fact, quite turned the heads of many, if not most, statesmen.

Society had not learned to use credit effectively; it had rather re-learned how to abuse it. The three years that have elapsed since the Armistice have in public, as well as in private, finance been marked by a credit debauch that is hardly paralleled in history. The appalling consequences of the policies that have been pursued are now revealed in the disillusioning figures of government debts and government budgets.

British National Debt

The following table,[1] shows the debt of Great Britian before the war and since the close of hostilities (in pounds sterling):

[1] *The Economist*, March 28, 1921.

	Total Debt
1914, Aug.	£ 700,000,000
1918, Nov.	7,120,000,000
1919, Mar.	7,481,000,000
1919, Dec.	8,079,000,000
1920, Mar.	7,876,000,000
1921, Mar.	7,630,000,000

It will be seen that during the war the British debt was multiplied tenfold. After the war the debt rose, in 1919, £600,000,000; but in 1920 and 1921 it declined slightly. It is clear that the expenses of government were then being met by taxation. [2]

The question presents itself, however, whether the heavy burden of taxation which the British public is enduring is not seriously impeding the economic life of the nation. This issue will be subsequently considered in an analysis of the uses to which the national income of Great Britain is now being devoted. It will there be shown that the burden of debt, together with other government expenses and unemployment insurance, are not only absorbing all the funds ordinarily available for new capital development, but are actually preventing the maintenance of the existing industries of the nation.

Some measure of alleviation from taxation in Great Britain might come if the Allied nations paid the £1,800,000,000 they owe Great Britain; but the chance that any of the Allied nations will be able to pay these debts is indefinitely remote. Indeed, the tentative proposal of Great Britain looking towards a cancellation of all inter-Allied debts arising from the war, affords evidence that she is not counting upon any positive fiscal relief from this source.[3]

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[2] For the estimates for 1922, see page 47.

[3] That Great Britain would have nothing to gain from an all-around cancellation of debts, may be seen from the fact that while the British

Indebtedness of French Nation

Let us now turn to the figures of French national indebtedness. The following table [4] shows the effects of the war (in francs, the foreign debts being estimated at current rates of exchange):

(In francs)

	Total Debt
1914, July 31	34,188,000,000
1918, Dec. 31	151,122,000,000
1919, Dec. 31	240,242,000,000
1920, Sept. 30	285,836,000,000
1921, Feb. 28	302,743,000,000

The French debt before the war was the largest of any of the national debts, per capita. In terms of percentage of national income, it also constituted one of the largest debts in the world.[5] This huge debt was multiplied during the war five times; and it has been exactly doubled since the Armistice. In the single year, 1919, the debt increased 89 billion francs. This increase must, in justice, be charged in no small degree to war expenditures incident to demobilization and the liquidation of war contracts.

But in the fourteen months following 1919, the debt rose from 240 billion francs to 302 billion francs, an increase of 62 billion francs, or almost twice the total of the enormous debt of 1914. Some of this amount is supposed to be recoverable from Germany through reparation payments. The budget for 1920 allowed for 20 billions "recoverable"

war debt to the United States amounts to £1,141,000,000, the debts of other Allied nations to Great Britain amounts to £1,731,000,000, which sum is exclusive of colonial obligations, amounting to £119,500,000. (League of Nations, International Financial Conference, Brussels, 1920, Paper IV, Public Finance, page 21.)

[4] La France Financiere et Economique, Tome I, page 305; Projet de loi du Budget, 1920, pages 162-3; *Ibid.*, 1921, pages 12, 13, 184, 185.

[5] Italy and Japan were the only other nations with as high a ratio of debt to income.

from Germany, and the 1921 budget for 16 billions. Thus for the fourteen months from January 1, 1920, to March 1, 1921, the total of such recoverable sums was about 23 billion francs. This leaves 39 billion francs (62 billion—23 billion francs) as the net increase in the French debt for the fourteen months ending March 1, 1920, for which the French people must stand responsible.[6]

Whether France is likely, in fact, to recover the other 23 billions from Germany must be left for later consideration.[7] It will suffice here to say that payments by Germany in the immediate future are not likely to result in any reduction of the French debt. The agreement entered into at Spa, whereby Great Britain was permitted to value surrendered German ships at the price at which the British government should eventually sell them, and the decision of the Reparations Commission to charge France at once with the total value of the coal mines of the Saar, together result in giving practically all the actual money accumulated in the Treasury of the Reparations Commission since May 1, 1921, to Allied nations other than France.

Foreign Debt

Much has been made by some people—even by American financiers—of the decrease in the French foreign debt during the last year or so. The decrease is approximately from 35 billion to 33 billion francs. This reduction, however, was not accomplished as a result of genuine saving in France. The French budget did not afford a surplus to be used for

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[6] The figures for French foreign indebtedness are usually computed in terms of current exchange rates, and, since French exchange fell during the period in question, not all of the increase is attributable to the excess of government expenditures over receipts. Perhaps 10 per cent of it is due to the fall in exchange rates, which affects the value of the foreign indebtedness.

[7] See Part II.

this purpose; nor did French foreign trade yield a favorable balance available to pay off foreign debts. It was merely accomplished by a shifting of obligations, by proportionately increasing the domestic debt.

Now it may possibly be good policy thus to reduce the French foreign debt at the expense of the domestic debt, but let no one be deceived thereby and led to believe that such a reduction in the foreign debt is evidence of fundamental improvement in French conditions.

As to the immediate future, it will be shown in a study of the French budget that there is certain to be a further large increase in the French debt during the current year.

These persistent increases of French national debt are obviously due to the reluctance, or inability, of the French government to raise sufficient revenue to meet expenses. The French people, unlike the British, are not yet shouldering the burden of war and post-war costs. They are still attempting to postpone the evil day.

National Debt of Italy

The following table shows the Italian national debt before and since the war:[8]

(In lire)

	Total Debt
1913, Dec.	15,000,000,000
1919, Dec.	84,000,000,000*
1920, June	95,000,000,000
1920, Dec.	100,000,000,000

* League of Nations International Financial Conference, Brussels, 1920.

It appears from these figures that Italy's national debt increased during the war more than five times. Moreover,

[8] From the Federal Reserve Bulletin, May, 1921.

since the war the debt has increased further in an alarming fashion. Thus the Italian situation is the replica of that in France. Italy has obviously not as yet demonstrated her financial solvency.

National Debt of Germany

Germany's national debt is as follows:[9]

(In marks)

		Total Debt
1914, July 1		5,300,000,000
1918, Dec. 31		140,000,000,000
1919, Dec. 31		197,000,000,000
1920. Oct. 27:[10]		
Funded and floating debt including interest on railroads taken over from federal states, etc.	287,000,000,000	
Compensation to German citizens arising out of the Peace Treaty	131,000,000,000	418,000,000,000

The German government financial statements are so complicated and so obscure that it is impossible to find out the precise status at any given time. Taking the above figures, however, as approximately exact, what conclusion may be drawn? With government debts expanding by billions of marks monthly, it cannot be said that Germany has as yet demonstrated her capacity, or willingness, to live within her means. In view of the greater rapidity with which the German debt is increasing, Germany may be said to be one step further down the scale of financial instability than are France and Italy.

[9] League of Nations, Brussels International Financial Conference, 1920, Paper IV, Public Finance, page 21.

[10] From General Report on the Industrial and Economic Situation in Germany, Department of Overseas Trade, London, 1920, page 57.

Other European Countries

Little would be gained by a study of the debts of other European countries. It may merely be stated that the neutral countries are infected with the same virus. This has been particularly the case since the war. The total debt burden in most cases is, however, not as yet of staggering dimensions.

As for the other countries of central and eastern Europe, figures of indebtedness which they furnished are so preposterously inadequate that it is useless to attempt a precise statement of the indebtedness of each. One may suspect that the governments of these countries do not even know the exact volume of their present debts. But it is known that in many of them the debt figures have now reached totals, as expressed in terms of their depreciated currencies, that are almost meaningless. There can be no doubt that they are much further down the scale than France or Italy or even Germany.

The conclusions to be drawn from the data given above are plain. Until the various European nations stop increasing their debts, they will not have evidenced their financial solvency. Until they demonstrate that they are able to raise each year sufficient revenue to meet running expenses, one cannot logically contend that European countries are convalescent and on the highroad to financial recovery.

CHAPTER V

NATIONAL BUDGETS

British Budget

Throughout the discussion of national debts we were face to face with the question of national expenditures and national revenues. Before the full significance of the present European fiscal situation can be appreciated, we must give careful consideration to the question of government budgets. Mounting public debts result from unbalanced government budgets—from government deficits. If we are to discern the future we must therefore ascertain the extent of the present fiscal deficits in the various European countries, and appreciate the extreme gravity of the taxation problem with which each is confronted. This will constitute the subject for discussion in this chapter.

How difficult, even impossible, is the task of balancing budgets in most European countries—unless correct principles are substituted for the aimless policies that now control the administration of national finances—can only be appreciated by a look at the precise figures of the various European budgets at the present time.

Attention will first be directed to the British budget, by far the most cheerful one to be considered. The figures for the years since the war are as follows:

	Revenue	Expenditures	Deficit
1919-1920	£1,339,571,381	£1,665,772,928	£326,201,547
1920-1921	1,425,985,000	1,195,428,000	230,557,000**
1921-1922*	1,058,150,000	974,023,000	84,127,000**

* Estimated.
** Surplus.

Real Situation

It would appear from these figures that Great Britain succeeded in 1920-1921 in balancing her budget, and that a surplus of £230,552,000 was available for debt reduction. The estimates for 1921-1922 indicate a further surplus of £84,127,000. It would seem, therefore, that Great Britain was in a satisfactory financial position, making slow but certain progress toward a reduction of the national indebtedness.

The British financial situation is not, however, so favorable as the above figures indicate. In the first place, the surplus of 1920-1921 is more nominal than real. In all other European countries, as will be seen, sufficient taxes have not been levied to balance the budget, and as a consequence the governments have had to borrow the amount of the deficits. In Great Britain heavy enough taxes have been levied to balance the budget; but it appears that many persons have borrowed funds from the banks in order to pay their taxes. The following quotation from the Right Hon. R. McKenna, formerly Chancellor of the Exchequer and now head of the great London Joint City and Midland Bank, Ltd., indicates what has occurred in Great Britain:

"Our (taxation) experience during the last year has taught us that there is a limit beyond which trade and industry cannot be burdened without grave danger to their strength and permanence. That limit is passed when traders are forced to borrow from their banks in order to meet their liabilities to the tax collector; and it is a fact that no inconsiderable part of the expansion of credit during the year which has just elapsed was due to this cause." [1]

The British method of having the taxpayers do the borrowing rather than the government, is doubtless superior to

[1] London Joint City and Midland Bank, Ltd., *Monthly Review*, January, 1921, page 5.

the continental method of government borrowing to make ends meet; for there is less danger of abuse of government power—less incentive to extravagance. But no one should be misled into the conclusion that Great Britain's finances are in an altogether satisfactory condition.

The estimated figures for 1921 also require some consideration. It appears that certain additional liabilities not included in the official budget will convert the £84,000,000 of estimated surplus into a deficit of £82,000,000.[2] The severe business depression will also affect the budget in a twofold manner: (1) by increasing expenditures, mainly for unemployment insurance; and (2) by greatly reducing the receipts from taxation. Unless the British people borrow tax money much more extensively from the banks than they did last year, there is little doubt that this year will show a substantial deficit. One need not be surprised if it should amount to well over £100,000,000.

French Budgetary Situation

It is a matter of common knowledge that France has not been able since the war to make financial ends meet. That is to say, expenditures have continually been greatly in excess of revenues, the differences being secured through further borrowing—in part from the general public through the sale of bonds and in part from the Bank of France. The following figures reveal the general situation:

(In francs)

	Receipts*	Expenditures	Deficit
1919	11,480,000,000	49,132,000,000	37,652,000,000
1920	19,735,022,000	45,987,358,000	26,252,336,000
1921**	23,262,969,977	46,321,413,889	23,558,443,912

* From taxes and miscellaneous sources, not including loans.
** Estimated.

[2] *Ibid.*, April 30, page 2.

The figures given in this table are not guaranteed to be accurate. There has been so much manipulation of figures and so much loose accounting in the presentation of French budgetary information that it is impossible for any outsider to ascertain the exact situation. No one who has not examined the detailed figures can have any conception of the extraordinary nature of the accounting legerdemain that is found in the Budget Général. The French budget has always been very difficult of precise interpretation; since the war it has been impossible. Only one conclusion may with safety be drawn from the figures as presented, namely, that they do not exaggerate the amount of the deficits. Moreover, the original estimates are usually greatly exceeded in the final reckoning, as the amount of the increase of the French debt indicates.

Extraordinary Budget

In order to gain a clear understanding of the French financial situation at present, it will be necessary to consider the figures of the French budget for 1921 in some detail. There are divers and sundry parts of the French budget, named in such a way as easily to lead to quite erroneous conclusions. For the 1921 expenditures they were as follows:[3]

	(In francs)
Ordinary budget	23,294,376,787
Extraordinary budget	3,253,209,391
Special "recoverable" budget	15,317,184,790
Special budget	595,527,763
Budgets annexes	639,753,400
	2,621,361,758
	600,000,000
Total	46,321,413,889

[3] Data taken from Budget Général de l' Exercice, 1921; and Journal Official de la Republique Française, Lois et Decrèts, 1921.

These numerous budgets require explanation. It is often insisted that France really balances her budget since the revenue is equal to the *ordinary* budget; it is only the *extraordinary* and other budgets on which France is in arrears. But the fact is that the true definition of the ordinary expenditure is such expenditure as it is believed can be balanced with revenues. Whatever the estimated revenues are in any year, that is (approximately) the ordinary expenditure. If one's income is $10,000 per year and his expenditures are $12,000, let him comfort himself by saying that his ordinary expenditures are only $10,000—that the additional $2,000 is extraordinary.

There might be some point to this method of budgetary accounting if the so-called extraordinary expenditures were in any sense special or temporary. The truth is they are not temporary; they are distributed among all the regular departments of government and there is not the slightest evidence that most of them are not of steadily recurring kind. Indeed, the evidence that this extraordinary budget is a mere subterfuge is found in the fact already mentioned—that the ordinary budget is always made to coincide with the volume of estimated revenues.

It must, therefore, be concluded that for the current year the French budget—exclusive of the special and annex budgets, which will be considered presently—fails to balance by at least the amount of the extraordinary expenditures, namely, 3,253,209,391 francs. We say by at least this amount, since it is possible that the revenues will fall short of the estimates and that the expenditures will exceed the estimates. The present estimates of revenue were made before it was clear how serious would be the effects of the business depression and the declining price level upon monetary profits and incomes. As a matter of fact it is already acknowledged in France that the revenues will fall much

below the original estimates. The sales tax has been most disappointing, yielding less than 50 per cent of the estimates; and there is the greatest difficulty in collecting other taxes. Last year's tax revenues amounted to 17,387,390,100 francs; and there is certainly no present reason for believing that this year's totals will exceed this amount. If this proves to be the case, the deficit for the ordinary and extraordinary accounts will total about 9 billion francs.

Other Budgets

Still postponing consideration of the special "recoverable" budget, we find three budget annexes, amounting to a total of 3,861,115,158 francs. The first of these, 639,753,400 francs, represents advances of the Treasury for the operation of the state railways. The second, 2,621,361,758 francs, is for administrative expenses in connection with the manufacture of moneys and medals, government printing, the legion of honor, etc. The third, 600,000,000 francs, is for material ceded to foreign countries. This presumably includes munitions and supplies to be furnished to Poland. These annex budgets increase the total deficit to more than 12,500,000,000 francs.

Of much greater importance are the "special" budgets. The second of the two, for 595,527,763 francs, is for the "maintenance of troops of occupation in foreign countries." The first, for 15,317,184,790 francs, is supposed to be recoverable from Germany under the terms of the Peace Treaty. It includes appropriations for war pensions and for the reconstruction of the devastated areas, including administrative expenses incident thereto. If these deficits be added to the others already discussed, the total for this year becomes more than 28 billion francs.

Since the Armistice, deficits in connection with reconstruction activities have been rapidly accumulating. Funds

for reconstruction, as well as for the payment of pensions, etc., are advanced by the French government on the theory that reparation receipts will eventually suffice to wipe out these accounts; hence the terms "special" and "recoverable." It will later be shown, however, that very little of the money expended by France for the reconstruction purposes or for pensions will ever be recovered.[4]

But if one prefers to give France the benefit of an unreasonable doubt and to assume for the moment that the "recoverable" budget will ultimately be recovered, the French deficit for the year still stands at about 13 billion francs.

Additional Obligations

Indeed, it appears certain that even this stupendous figure will not tell the whole tale. According to an eminent American financier, who has devoted several months to a study of the French economic and financial situation, the Senate Commission of France estimates that in addition to the ordinary and extraordinary and recoverable budgets "the Treasury must find 18 billions more to provide for supplementary credits, stipulated repayments of external debt, arrears of payment on previous budgets, deficits on special services, reduction of advances from the Bank of France, and a billion francs of advances on the railways."

Some of these items apparently duplicate those in the budget annexes already mentioned, and some of them represent new obligations created for the reduction of old ones. But they are not all duplicate items; and if we may judge from the experience of the last two years, they will constitute very heavy additions to the deficit for the year. The financier in question estimates the total French deficit for the year 1921 at 35 billion francs, less whatever may be recovered from Germany. These figures are, moreover, based

[4] See Part II on reparations.

on the assumption that the estimated revenues for the year are not exaggerated.

It is, however, impossible to arrive at any very precise estimate of the probable extent of the French deficit this year. Twenty billion francs, exclusive of the 15 billions "recoverable," does not, however, appear to be an excessive figure. This would add 20 billion francs to the French debt in the third year after the war; and if Germany does not pay, it would add 35 billion francs.

It should be remembered also that the French budget figures do not include interest charges on the huge foreign debt of France, incurred during the war. Payment of interest on inter-Allied debts has been indefinitely postponed.

Belgian Finances

The condition of the Belgian budget is very similar to that of France. In the year 1920 the total expenditures were 8,578,454,000 francs and the revenues 3,020,702,000 francs, leaving a deficit of 5,557,752,000 francs.[5] The estimates for 1921 call for expenditure of 9,689,742,307 francs and revenue of 5,108,053,222 francs, giving a deficit of 4,581,689,085 francs. The detailed figures are:[6]

(In francs)

		Deficit
1. Ordinary:		
Expenditures	3,802,840,692	
Revenue	3,119,227,222	683,613,470
2. Extraordinary:		
Expenditures	3,127,695,765	
Revenue	1,692,074,000	1,435,621,765
3. Under Treaties of Peace:		
Expenditure recoverable	2,759,565,850	
Reparations paid	296,752,000	2,462,813,850
Total		4,582,049,085

[5] League of Nations International Financial Conference, Brussels, 1920, Vol. III, page XI.

[6] For the year 1921 the figures are estimates. Data taken from *The Economic Review,* April 8, 1921, page 395.

Here is the same major classification of expenditures as in France, the same effort to make things appear better than they are. It will be noted, however, that in this case even the ordinary budget does not balance.

The German Budget

In view of the widespread expectation that the budgets of Allied nations are to find relief from the receipt of German reparations, much importance attaches to what has transpired in Germany since the Armistice in the matter of government finances. Attention may, therefore, be called to the following figures:

(In paper marks)

	Expenditures	Receipts	Deficit
1920[7]	51,892,363,000	27,770,000,000	24,122,363,000
1921[8]	110,200,000,000	40,000,000,000	71,200,000,000

Discouraging as these figures are, they do not tell the worst of the story. They are but preliminary estimates of expenditures and revenues; and in consequence of the disordered economic life of Germany, the estimates have to be radically changed almost from month to month. The final figures, therefore, always greatly exceed the estimates, as the statistics of mounting indebtedness clearly show. For example, between September 20, 1920, and October 27, 1920, the "floating" debt increased by 5 billion marks, an increase at the rate of more than 50 billion marks per annum.[9] This compares with the estimated deficit for the entire year of only 24 billion marks. From April 1, 1920, to April 1, 1921,

[7] League of Nations International Financial Conference, Brussels, 1920, Paper III, page XI.
[8] General Report on the Industrial and Financial Situation in Germany in December, 1920, Department of Overseas Trade of Great Britain, 1921, page 58.
[9] *Ibid.*, page 57.

the floating debt appears to have actually increased by the staggering sum of 74 billion marks.[10]

Moreover, these budgetary figures do not include all the items of government expenditure. For example, they do not include 131 billion marks expended for compensation to German citizens arising out of the Peace Treaty, i.e., for the ships of the mercantile marine, the liquidation of German property abroad, the delivery of war material, etc.[11] Nor do they include reparation payments that Germany has agreed to make, which, on the basis of exchange rates in June, 1921, would add 60 or 70 billion paper marks to the annual budgetary requirements of Germany.

Other Countries

Other European budgets in 1920 were as follows:[12]

(000 omitted)

	Expenditures	Receipts	Deficit	Ratio of Receipts to Expenditures
Italy	28,450,000 (lire)	9,520,000	18,930,000	33%
Austria	33,194,000 (kronen)	20,655,000	12,539,000	63
Hungary	20,210,748 (kronen)	10,539,947	9,670,801	52
Greece	1,874,003 (drachma)	636,325	1,237,678	34
Portugal	235,525 (milreis)	110,414	125,111	47
Bulgaria	2,994,903 (liva)	1,803,000	1,191,903	60
Czechoslovakia	10,416,771 (kronen)	7,750,771	2,666,000	74
Finland	1,163,968 (marks)	778,717	385,251	67
Poland	15,189,679 (marks)	3,127,625	12,062,054	21
Holland	724,192 (guilders)	615,183	109,009	84
Norway	584,085 (kronen)	529,937	54,148	89
Sweden	890,888 (kronor)	852,027	38,861	95
Spain	2,403,730 (pesetas)	1,842,721	561,009	77
Switzerland	604,066 (francs)	385,400	218,666	64

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[10] Federal Reserve Bulletin, July, 1921, page 808.

[11] General Report on the Industrial and Economic Situation in Germany in December, 1920, Department of Overseas Trade of Great Britain, 1921. Compare also with the statistics of Germany indebtedness given on page 45 above.

[12] These figures are all taken from Proceedings of the League of Nations International Financial Conference, Brussels, 1920, Vol. III, page XI.

These are the figures for every country of any consequence in Europe for which relatively complete data are available. It will be seen that not a single nation outside of Great Britain even nominally balanced its budget in 1920. Even the neutrals are not making ends meet. It should be added that these figures are estimates only; and that in many cases, especially in central and eastern Europe, the final returns will show very much larger deficits than these preliminary figures would indicate.

In the year 1921, moreover, the deficits will doubtless be larger than in 1920, with scarcely an exception.[13] As in the case of Great Britain and France, the finances of almost all European nations are this year suffering severely because of the business depression. Receipts from taxation will fall below the estimates; and in most nations expenditures will be enlarged in consequence of the increased volume of unemployment insurance that must be paid.

The Burden of Taxation

One of the simple formulas which one hears advanced as a solution for the European fiscal problem is that nations must raise their taxes and courageously shoulder the burdens of war cost. It will be instructive, in the light of this suggestion, to consider just how heavy a taxation burden would be required in some of the leading European countries if budgets were to be balanced by the process of raising taxes.

In the United Kingdom, according to recent estimates made by Edgar Crammond,[14] a British statistician, the cost of national government in Great Britain in 1920 absorbed

[13] An exception may perhaps be made for Italy, where inflation has been continued. This means, merely, that Italy has yet to face the music.

[14] In an address before the British Institute of Bankers, in June, 1921; published in the *London Times,* June 28, 1921. For further discussion of Crammond's analysis, see page 132.

approximately 23 per cent of the national income. That is to say, out of every $100 earned by the British people, $23 went to the government in taxes. Mr. Crammond further calculates that in view of the great shrinkage in national income in consequence of declining values and the business depression, it will require this year approximately 32 per cent of the national income to pay the cost of government. He adds that "no great industrial nation which has such urgent need of capital as Great Britain and whose capital reserves have been so severely weakened by a great war could possibly afford anything approaching 32 per cent of the entire national income for national services without endangering the whole economic fabric. For four months of the year we should all be working simply for the purpose of paying the cost of government and imperial defense." As we have already seen, Great Britain will probably not be able to make ends meet this year.

In France the total expenditures, including those for pensions and reconstruction, will this year exceed 40 per cent of the national income. Exclusive of the supposedly "recoverable" expenses, the expenditures will be at least 30 per cent of the national income. Present French tax receipts equal only 18 per cent of the national income.[15] The Italian situation is similar to that of France. In 1920 the expenditures equaled 30 per cent of the national income; while the revenues were only 13 per cent.[16]

As regards Germany, and the countries of eastern Europe generally, because of the paucity of reliable data, it is impossible to compute with any degree of accuracy the percentage of national income that would be required to meet the present expenditures. The League of Nations Financial

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[15] League of Nations International Financial Conference, Brussels, 1920, Paper IV, page 15.
[16] *Ibid.*, pages 15, 16.

Conference puts the 1920 expenditures of the national government in Germany at 23 per cent of the national income and the revenues at 12 per cent.[17] But as we have seen in the analysis above (page 55), the German budget figures are by no means inclusive, even apart from reparations. Including reparations, there is little doubt that more than 50 per cent of the national income of the German people would be absorbed to meet the present expenditures of the German national government alone. The various state and municipal expenditures—which are more important under the federal governmental systems of Germany and the United States than they are under the more highly centralized systems of France and England—constitute a heavy additional burden.

Question of Further Tax Increase

In contemplating these figures of taxation burden, it is important to remember that the less the national income per capita in any country, the more heavily weighs the load of taxes. Wealthy nations like the United States and Great Britain might bear a taxation burden equal to 25 per cent of the national income, while such a ratio might prove impossible in poorer countries like France and Italy. The extent of the variation in tax-paying power in different countries may be seen from the following estimates of per capita national income in 1920:[18] the United States $700; the United Kingdom $445; France $265; Italy $130; and Germany $103.

The taxes collected by the federal government in the United States in 1920 equaled only about 8 per cent of the

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[17] *Ibid.*

[18] The figures are all taken from League of Nations International Financial Conference, Brussels, 1920, Paper IV, page 15. Later (authoritative) estimates for the United States show only a little over $600 per capita. Because of the shrinkage in values, 1921 figures will everywhere be greatly reduced.

national income. Notwithstanding our relative affluence as a nation, our business and financial interests regarded this load as utterly ruinous, destructive to all initiative, and promotive of rapid economic deterioration. While our business community has probably somewhat exaggerated the magnitude of the existing taxation burden, contemplation of the American agitation for fiscal relief helps one to understand how the impoverished peoples of Europe must regard their taxation problems. It makes one question whether any further increase of taxation is politically, or economically, possible. Indeed we shall find in subsequent discussions that doubt of European ability to increase taxes—at least to anything like the extent that would be required to meet present expenditures—is well-founded. [19]

Now if budgets cannot be balanced by raising taxes, the only other alternative is to reduce expenditures. This method has, of course, also been urged upon the statesmen of Europe. Indeed, the full formula for fiscal reform is usually to increase taxes and decrease expenditures simultaneously, so as to bring income and outgo into the necessary equilibrium. How difficult, nay how impossible, it is to reduce governmental expenditures materially so long as present conditions, both political and economic, exist, will also be revealed in a subsequent discussion. For the moment we must be content with a mere statement of the two-horned dilemma.

Burden of Domestic Debts

There is a widespread impression, however, that the internal or domestic debts of a country do not constitute a real burden on the people. Is not the money that is turned over to the government in the form of taxes paid back to the

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[19] See Chapter X on economic and social disintegration.

people themselves in the form of interest on the public debt, in pensions, etc.? Now it is undoubtedly true that the interest on the domestic debt and other domestic expenditures accrue to the people of any given country in the form of revenue. But the trouble with the foregoing impression is that the particular individuals who pay taxes do not usually receive back in interest, pensions, etc., anything like the precise amount of funds that they have parted with in the form of taxes. Some receive a great deal more from the government than they pay to the government; others receive a great deal less. It thus involves a wholesale redistribution of wealth. This is, no doubt, particularly the case in a country such as Great Britain where the tax burden on the well-to-do classes is extremely heavy and on the poorer classes relatively light.

What happens under such circumstances is that one class of the community furnishes the means whereby another class is enabled to live in idleness—partial or complete. A very large percentage of government expenditures goes for past services, in the form of pensions, or as interest on funds loaned to the government. Those who receive the funds are no longer rendering a quid pro quo.

In a country such as France where the national income is more evenly distributed and where the tax burden is more equitably laid, this effect of a huge domestic debt is not so great. But if France were to undertake the task of increasing taxes sufficiently to balance her budget, even there the burden on the well-to-do class would have to be tremendously increased. Even there, moreover, no small percentages of the government expenditure goes to reward past services and thus to permit people to live without exerting present economic effort.

The most serious result of unbalanced budgets and mounting national indebtedness is the effect upon the banking

and monetary systems of nations, and thence upon the whole economic organization. National budgets, persistently unbalanced, will ultimately wreck the entire financial and economic system. Just why and how must, however, be left for elucidation in subsequent chapters. [20]

[20] See Chapter VI for a general discussion of European banking and monetary systems; Chapter VII for the effects of unbalanced budgets upon the German financial system; and Chapter X for a discussion of the difficulties involved in balancing budgets and of the effects thereof upon the whole social and economic fabric.

CHAPTER VI

THE EUROPEAN MONETARY SITUATION

European Central Banks

There has been no end of discussion in the literature of post-war finance of the continued inflation of European currencies. It is a matter of common knowledge that many of the European countries have been able to keep their financial heads above water only by the continuous resort to the desperate expedient of the printing press. The truth is that in nearly all of Europe east of the Rhine the manufacture of paper currency has proceeded since the Armistice at a much more rapid rate than during the war period itself, and at a rate that hardly finds a parallel in history. In the nations of western Europe the only difference is one of degree. This chapter analyzes the condition of the European monetary and banking systems for the light they throw upon the general economic situation in Europe.

The increase of paper money in circulation in Europe has largely been brought about by bank note issues. That is to say, the paper money has been issued mainly by the banks rather than by the governments direct. Accordingly, an appreciation of the significance of the monetary situation requires an understanding of the process by which the currency is issued and of the effects of such issues upon the condition of European bank reserves. Only a few relatively simple considerations are involved.

In each of the European countries there is a central bank, comparable in its functions to the federal reserve banks of the United States. In brief, these central banks are bankers' banks, that is to say, they make loans to and hold deposit

accounts for the individual private banks, much as the individual banks make loans to and hold deposits for private individuals. In normal times the ordinary banks do not need to borrow much from the central institutions, as they have sufficient funds of their own to take care of all business requirements. But whenever there arises a very active demand for money, these banks are compelled to borrow the additional funds required from the central banks, whose duty it is to maintain large reserves for just such emergencies.

Currency Inflation

When early in the war there arose an abnormal demand for funds with which to finance the production of war materials, it immediately became necessary for the individual banks to enlarge their borrowings from the central reserve institutions. Now since on the continent of Europe it is customary to employ bank notes rather than checking accounts, borrowing from the central bank usually resulted in an issue of central bank notes to the individual bank. These notes were in turn loaned out by the individual banks for the purposes of business. If it had not been for the steadily rising prices during the war and the period which followed, the expansion of loans by this process would not have continued indefinitely. But the higher prices rose and the more wages advanced, the more funds it took to finance a given volume of business. [1] Accordingly, every business man had steadily to increase the volume of his borrowing from banks, and in turn every individual bank had steadily

[1] There is divided opinion among students of finance as to whether the rise in prices was caused by the expansion of loans. One group holds that if the banks had refused to advance loans, prices would not have risen and the additional volume of funds would, therefore, not have been required; another group holds that prices rose for other reasons and that the expansion of loans was a result rather than a cause of rising prices.

to increase the volume of its borrowing from the central bank.

At the same time, the various governments when in need of funds usually found it more expedient to borrow the amounts required from the central banks than to raise them exclusively through taxation. Moreover, when government bonds were sold to the general public, a considerable percentage of the funds used in buying them was borrowed from the central bank. The process may perhaps best be made clear by reference to what happened in the United States, where similar financial methods were followed.

The people were asked to borrow on the security of previous Liberty bonds, or other collateral, to the limit of their capacity, and to invest the funds thus procured in Liberty bonds. The banks from which the people borrowed, in turn, secured the funds which they loaned through borrowing from the Federal Reserve banks, on Liberty bonds as collateral. The individual banks also invested huge sums in Liberty bonds on their own account, again borrowing the funds from the reserve banks.[2] It must be noted, in this connection, that the funds which are thus drawn from the reserves of the central banks constitute additional money in circulation. The process described is what is commonly known as currency inflation.

Bank Reserves

Now all this borrowing from the banking institutions naturally reduced the reserves of the central banks. A few words are necessary as to the meaning of reserves. Experience has demonstrated that if a bank has notes (that is, promises to pay cash) outstanding in the hands of indi-

[2] There is also divided opinion among students of finance as to the merits of this method of financing the war. We are, however, interested here only in showing the effects of the process upon the condition of bank reserves.

viduals of $100,000, for example, it is not necessary for it to hold as much as $100,000 in specie as a reserve for redeeming them. This is because there is little possibility that all of the notes will, at any one time, be presented for payment in cash. It is merely necessary for the bank to keep on hand such an amount of specie as experience has shown is necessary to enable it at all times to meet the actual demands that develop. In England and in the United States where checking (deposit) accounts are mainly used instead of notes, the same principle holds. It is unnecessary for a bank to keep a reserve against the deposits of individuals equal to 100 per cent of such deposits; it is necessary to keep only such a percentage of cash to deposits as experience has shown will enable the bank always to be in a position to pay cash when it is demanded.

The same principle also holds with reference to the reserve of the central, or bankers' banks. They must keep only such ratio of cash to notes and deposits as experience has shown to be necessary in order to maintain specie payments.

It will be seen at once that since the individual banks can borrow, when in need of additional cash, from the central banking institutions, they do not have to keep very much cash on hand. The truth is that not more than 5 per cent of the amount of the outstanding deposits and notes is usually kept by individual banks in the form of cash. But since the central reserve banks have no similar borrowing resources, they must necessarily keep much larger reserves. In the United States the law requires a minimum reserve in the federal reserve banks of about 40 per cent against notes and deposits. [3] But it is the policy of the federal reserve managers to keep reserves in ordinary periods very greatly

[3] To be precise it is 40 per cent against federal reserve notes and 35 per cent against deposits.

in excess of this amount, in order that in time of emergency they may be able to issue more notes and lend more money to the member banks than would otherwise be possible. In Europe it is not usually customary for the law to fix a legal minimum reserve; but the practice has nevertheless been for the managers of the central reserve institutions to keep very high reserves, usually from 50 to 70 or 80 per cent, the percentages varying somewhat at different times and in different countries.

Effect of War Finance upon Reserves

Such was the condition of affairs at the outbreak of the European war. The great demand for funds that shortly developed, however, resulted in a rapid lessening of the ratio of gold reserves to outstanding claims against gold. It was early seen that the financial strain would be extremely heavy, and as a means of conserving the gold supply the various European central banks soon suspended specie payments. That is to say, they refused to redeem the paper currency in gold when it was presented at the bank for payment. Paper currency thus ceased to be interchangeable with gold; it became irredeemable, and it depreciated in value as the chance for an ultimate resumption of specie payments became more and more remote.

The aggregate gold holdings of the central banks of Europe were actually increased in consequence of this refusal of the banks to part with gold, on the one hand, and, on the other, because of the actual transference of gold from the channels of commerce to the coffers of the banks. But it nevertheless proved impossible in all of the belligerent countries to prevent a decrease in the percentage of gold reserves to notes and deposits, on account of the numerous outpourings of paper currency.

For similar reasons, the reserves of the Federal Reserve

banks of the United States were drawn down during the course of the war from a maximum of nearly 90 per cent to about 52 per cent at the time of the Armistice. The reserves of the central banks of the European belligerents were in most cases reduced much further during the war than were those of the federal reserve banks in the United States. This was because of the smaller original pre-war ratio of gold to outstanding note and deposit liabilities in the European banks, and because of the greater intensity of the financial strain in consequence of Europe's longer participation in the struggle.

The data in the table below show the changes which occurred in the percentage of gold and silver reserves to note and deposit obligations in the leading nations of the world, from the time each entered the war until (with the few exceptions noted) the spring of 1920.[4] This table will at once reveal the disastrous effects of war finance upon the banking systems of the world, and provide a background for a consideration of the trend of monetary development in the several European countries during the past twelve months.

THE WAR'S EFFECT ON WORLD BANKING SYSTEMS

(000,000 omitted)

Country	Gold and Silver Holdings		Note and Deposit Obligations		Reserve Percentage		
	1914	1920	1914	1920	1914	1920	
(A) ALLIED POWERS							
United States (a)..	$ 947	$2,078	$1,064	$5,907	89.0%	42.2%	(b)
Great Britain	186	547	472	1,131	39.4	48.4	(c)
France	920	1,122	1,547	7,986	59.5	14.1	
Italy (d)	288	222	462	2,891	62.3	7.7	

[4] The table is compiled from data assembled by Louis Ross Gottlieb, published in the Bankers Statistics Corporation, New York, 1920, in an article entitled, "The Banking Situation of Foreign Countries."

Country	Gold and Silver Holdings 1914	Gold and Silver Holdings 1920	Note and Deposit Obligations 1914	Note and Deposit Obligations 1920	Reserve Percentage 1914	Reserve Percentage 1920
(A) Allied Powers—*Continued*						
Russia (e)	937	1,948	1,408	11,236	66.5	17.3
Japan	109	467	239	1,306	45.6	35.8
Belgium	61	69	240	1,395	25.4	4.9
Greece	45	286	89	470	50.6	60.9
Roumania	41	293	89	1,280	46.1	22.9
Portugal	18	29	98	447	18.4	6.5
Finland	7	8	28	259	25.0	3.1
Total Allied Powers	$3,559	$7,069	$5,736	$34,308	62.0	20.6
(B) Central Powers						
Germany	$ 402	$ 255	$ 675	$15,339	59.6	1.7
Austria-Hungary	312	58	491	13,443	63.5	0.4
Turkey	21	46	75	92	28.0	50.0
Bulgaria	25	13	80	615	31.3	2.1
Total Central Powers	$ 760	$ 372	$1,321	$29,489	57.5	1.3
Total Active Belligerents	$4,319	$7,441	$7,057	$63,797	61.2	11.7
(C) Neutral Powers						
Total Neutrals (f)	$ 765	$1,559	$1,325	$ 3,242	57.7	48.1
Grand Total	$5,084	$9,000	$8,382	$67,039	60.1	13.4

(a) Figures for the United States are for March 30, 1917. They include only the Federal Reserve banks.
(b) The ratio is computed on the basis of *gross* deposits.
(c) The British reserve ratio here appears to be higher than it really is; for the "currency notes," amounting to $139,000,000, which are issued by the government instead of the Bank of England, are not included. If these be included, the reserve ratio is cut in two. See special table on the following page.
(d) Figures are for the three Italian banks of issue. Legal tender notes are included in the gold and silver holdings.
(e) The Russian figures are for October, 1917. At the present time the returns would, of course, be wholly different.
(f) The neutral nations include: Argentina, Brazil, Denmark, Netherlands, and Switzerland.

Banking Position in Great Britain

In Great Britain both the Treasury and the Bank of England have issued currency with which to finance the

requirements of war and reconstruction. Hence the combined accounts of the Bank and the Treasury given in the following table will best reveal the true financial status of the country and the drift during the past year.[5]

(£000,000 omitted)

	Bank Notes	Currency Notes & Certificates	Deposits	Coin & Bullion	Reserve*	Govt. Floating Debt
1913, average	£29		£57	£38	44.2%	
1920, Jan., ...	84	£330	155	128	22.5	£1,319
1920, June, ...	107	357	192	146	22.3	1,294
1920, Dec., ...	113	367	190	157	23.4	1,408
1921, June, ...	110	324	147	157	27.0	1,374

* Ratio of coin and bullion to notes and deposits.

For the first year and a half after the Armistice, the volume of outstanding notes and deposits rapidly increased, and the reserve percentage touched bottom in June, 1920. Although outstanding liabilities expanded until the end of 1920, the increase in coin and bullion was enough to raise the reserve ratio about one per cent. The first six months of 1921 reveals a reduction in both bank and currency notes, and deposit obligations, with a resulting material improvement in the reserve ratio.

The floating debt of the government, consisting mainly of Treasury bills, or short-time promises to pay, also decreased somewhat during the first half of the current year (1921), although the amount now is larger than it was twelve months ago. It is not improbable that the second half of 1921 will show a new increase, in consequence of current budget difficulties, discussed in the preceding chapter.

Banking Situation in France

French financial statistics have not been complicated by government notes, all issues having been made through the

[5] Data taken from Federal Reserve Bulletins.

Bank of France. The following table giving the condition of the Bank of France shows the trend of French banking:[6]

(In francs, 000,000 omitted)

	Note Circulation	Deposit Obligations	Gold and Silver	Reserve* Ratio
1913, Dec.	5,723	984	4,164	62.1%
1918, Dec.	30,200	2,484	3,765	11.5
1919, Dec.	37,336	3,211	3,874	9.5
1920, June	37,915	3,751	3,972	9.5
1920, Dec.	37,902	3,575	3,818	9.2
1921, June	37,422	2,861	3,846	9.5

* Gold and silver to note circulation and deposit obligations.

It will be seen that although the reserve percentage has improved slightly during the past year, the ratio is still lower than it was at the time of the Armistice. While the note circulation has declined but little, there has been a material reduction in deposit obligations since the end of 1920.

Italian Financial Situation

The following data [7] show the condition of Italian banking:

(In lire, 000,000 omitted)

	Note Circulation	Deposit Obligations	Gold Reserve	Reserve* Ratio
1913, Dec.	2,284	318	1,661	63.9%
1920, Jan.	15,634	2,376	2,021	11.2
1920, June	17,817	2,379	2,110	10.5
1920, Dec.	19,731	2,559	2,077	9.3
1921, March	18,765	2,461	2,043	9.6
1921, June	18,159	2,366	1,989	9.7

* Gold reserve to note circulation and deposit obligations.

[6] Data taken from Federal Reserve Bulletins.

[7] The figures are for the Italian banks that are privileged to issue notes. They differ somewhat from those on page 68, because they include foreign specie holdings.

The Italian situation, it will be seen, resembles very closely that of France. There has been a slight improvement in the reserve ratio during the first half of 1921.

Banking Situation in Germany

The following data show the trend of banking conditions in Germany during and since the war. The figures are for the central Reichsbank:

(In marks, 000,000 omitted)

	Notes in Circulation	Deposits	Gold Reserve	Reserve* Ratio
1913, Dec.	1,958	668	1,068	40.7%
1918, Dec. 31.......	22,206	13,828	2,281	6.3
1919, Dec. 31.......	35,723	17,095	1,109	2.1
1920, Dec. 31.......	66,806	22,327	1,092	1.2
1921, May 31.......	71,839	14,093	1,092	1.3
1921, July 31.......	77,391	15,814	1,092	1.17

* Gold reserve to note circulation and deposit obligations.

The figures for Germany reveal an appalling situation. The enormous expansion in note issues and deposits carried the reserve ratio down from 40.7 to 6.3 per cent during the period of the war. Since the Armistice the gold supply of the Reichsbank has been cut in two, and the volume of outstanding notes and deposits has been considerably more than doubled. During the single year 1919, the note issues of the Reichsbank were increased over 60 per cent, and in the year 1920 almost 100 per cent.

There is still another form of paper currency in Germany, known as *darlehnkassenscheine.* [8] These notes are issued by certain so-called "loan banks." Though they are now permitted to be used as reserve money, they are not redeemable in gold. The volume at present in circulation is

[8] For a further statement with reference to these notes, see footnote on page 83.

8,358,000,000 marks. To measure the full extent of the inflation in Germany this figure should be added to the totals in the above table.

Reserves of Other Countries

There is no need of going into detailed figures for other European countries. It is enough to point out that the condition of Belgium and of neutral countries resembles that of France and Italy, in that the volume of outstanding notes and deposits has ceased to expand within the past year and the proportion of gold to paper money is now increasing slightly. The minor countries of central and eastern Europe are in most cases in a worse condition than Germany. The manufacture of paper money is still a major industry, and gold reserves are still rapidly declining.

Inflation Still Unchecked

Many American students of European conditions contend that European inflation has now been definitely checked; and they find in this asserted fact the most hopeful, single evidence of European recovery. This oft-repeated statement is not true. Inflation is as violent as ever in central and eastern Europe, and continues everywhere on the continent, notwithstanding the figures in the foregoing tables.

To understand why the assertion that inflation remains unchecked can be made in the face of the evidence that bank note obligations have ceased to expand in western Europe, one must appreciate that there are two kinds of inflation. The first results from rising prices and booming business, with heavy borrowing from banks by business and commercial interests. It may be designated as "commercial" inflation. The second results from government borrowing for the purpose of meeting government deficits. It may be called "governmental," or "fiscal" inflation. Now

it is only the former type of inflation that has been checked.

The business depression and accompanying price liquidation has, in Europe as in the United States, very greatly reduced the demands made upon the banks for commercial and business loans. The business depression has checked business inflation; but it has not checked government inflation. Indeed, the business depression, through increasing the amount of the government Treasury deficits, will this year cause a greater recourse to government loans from the banks—in nearly every European country—than at any time heretofore. Fiscal inflation is on the increase.

The total volume of outstanding notes of the Bank of France, for example, has declined slightly since last autumn. But this merely indicates that the reduction in the volume of note issues for commercial purposes has during this period been somewhat greater than the increase in the volume of note issues for government fiscal purposes. Now when the process of business liquidation shall have run its course, there will be no further reduction in the volume of business borrowing. And thereafter, so long as government borrowing for the purposes of balancing budgets continues, the volume of outstanding note issues will again increase and reserves will again fall.

Germany and other central and eastern European countries now differ from those of western Europe chiefly in that in them the expansion of government borrowing has more than offset the recent contraction of business borrowing.[9] This is mainly because the budgets of these countries are less nearly balanced than are those of the western belligerents. In consequence, the total of outstanding notes continues to expand, even in the face of business depression.

[9] That there was commercial contraction in Germany early in 1921 may be seen from the decline of deposits, as shown in the table on page 72.

General Conclusions

What, now, are we to conclude from this analysis? What if the volume of outstanding notes and deposits is enormous; what if the reserve percentage is unprecedentedly low, and in a large part of Europe still declining? Does the present situation necessarily foreshadow disaster? Of England it may be dogmatically stated that there is little occasion for alarm, so far as the purely banking aspects of the situation are concerned. The reserve is increasing steadily—in aggregate volume—and the percentage of gold to paper money is steadily increasing. The Bank of England is headed in the right direction—moving toward a condition where specie payments can be resumed and the British monetary system restored to a gold basis. That the progress will be slow, however, is evident from the renewed borrowing by the government from the Bank of England in recent months—in consequence of the severe business depression and the resulting decline in receipts from taxation.

The same conclusion does not hold, however, in regard to continental Europe. The condition of the central banks of France, Belgium, and Italy is such that it will be many years, at best, before specie payments can possibly be resumed. Indeed, there are many who believe that it will be quite impossible for them ever to restore the pre-war gold value of their currencies. It is pointed out that no bank in history—in similar condition—has ever succeeded in building up a gold reserve and in reducing outstanding note issues sufficiently to permit the resumption of specie payments.

The principal reasons for doubting the ability of these nations to resume specie payments and thus to restore the pre-war value of their paper currencies, is the budget situation discussed in Chapter V. Unless budgets can be balanced there is no escape from a progressive deterioration

of the banking position. This, of course, applies equally well to the neutral countries.

Unless the truth of this observation is clearly perceived, one cannot reach a full understanding of the gravity of the European situation. Unbalanced budgets will in time wreck the entire monetary and banking situation. Moreover, so long as irredeemable paper remains the basis of values in Europe, prices will remain unstable, and foreign exchange, for reasons discussed in Chapter II, will remain depreciated and continue to fluctuate to the serious detriment of both foreign and domestic business.

In Germany the depreciation of the currency and the demoralization of the financial system has already reached an acute stage. The German financial situation represents an intermediate stage between that of the distressed countries of western Europe and the bankrupt countries of the east. It, therefore, offers an excellent opportunity for an analysis of the process whereby a nation whose budget is seriously unbalanced and which is committed to the unlimited issue of home-grown currency, must inevitably end in financial disaster. Accordingly, the succeeding chapter is devoted to a study of the future of German currency.

CHAPTER VII

THE GERMAN MONETARY COLLAPSE

Additions to Gold Supply Impossible

Whatever may be the ultimate outcome of the monetary and banking situation in western Europe, there is little doubt of the future in Germany and in the other nations of central and eastern Europe. It is impossible to conceive how these countries can ever reach a position where they can redeem the present outstanding currencies.

Progressive deterioration of the reserve and progressive depreciation of the currency appear inevitable. Of such tremendous importance is a clear understanding of what lies in store for central and eastern Europe to an appreciation of the whole problem of European rehabilitation, that a careful analysis of Germany's inevitable financial future is required.

In the first place, it is impossible for the Reichsbank to increase its gold holdings. Practically all of the gold supply of Germany is now in the Reichsbank; there is no more that can be withdrawn from the channels of circulation. And since Germany is not a gold-producing country, she can add to her total stock of gold only by importing it. Let us see what this involves.

In the previous discussion of the foreign exchange mechanism,[1] it was shown that gold will flow to a nation only when the volume of exports exceeds the volume of imports—allowance, of course, being made for the other items entering into the international scale-pans. But in

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[1] See Chapter II.

the case of Germany, under present conditions, no gold can be received until the exports exceed the imports by more than the amount of the annual reparations payments, which, as will be seen in later discussion, can in the main be made only by the shipment of goods abroad. The subsequent discussions of the terms of the reparation settlement will indicate that for something like a half century Germany cannot expect to receive any appreciable inflow of gold.

Deflation of Currency

Could Germany, by reducing her outstanding circulation sufficiently, resume specie payments? Suppose we consider first the possibility of resumption upon the basis of Germany's existing gold supply—assuming, for the time being, that none of it is exported in reparations payments. To what extent would the German currency have to be deflated in order to make possible a return to the pre-war gold standard? In the United States a minimum of 40 per cent reserve in the federal reserve banks is considered essential to the maintenance of specie payments. Before the war the German banking law required a reserve of at least 33 per cent against outstanding notes. Much more than this was, in fact, ordinarily maintained. While other leading countries required no definite reserve, practical experience had in all cases led to the maintenance of large specie holdings. [2] But it is doubtless possible to effect a restoration of gold redemption on a much narrower gold basis than was formerly the case. Assume, therefore, that the accumulation of a reserve of 20 per cent would be sufficient. What amount of deflation would this require, and what would be involved in the process?

The amount of outstanding Reichsbank notes now stands at about 80 billion marks, and the reserve at slightly more

[2] See table on page 68 for the reserve in 1914.

than 1 billion marks. (The outstanding deposit claims amounting to more than 15 billion marks are here omitted from consideration.) To make the reserve of 1 billion marks equal to 20 per cent of the note issues would require a reduction of the notes to 5 billion marks. Seventy-five billion marks, over 80 per cent of the entire momentary supply, would have to be eliminated from circulation.

To understand the full significance of so drastic a contraction of the currency, it must be recognized that it would involve a reduction of bank loans to roughly one-sixteenth of the present total. Such a drastic reduction of loans would produce complete business prostration and result in almost universal unemployment. It would also involve the cessation of unemployment insurance and pensions, and a failure to cover by new loans the huge governmental and railway operating deficits.[3] No government could last which resolutely undertook any such contraction of bank loans; the certain results of attempting it would be political revolution.

If the contraction were sought to be effected only very gradually—say in fifty years—there would merely be a prolongation of the agony of deflation, and an apparently perennial era of desperately hard times. Prosperity never accompanies contraction of currency and falling prices. Neither the Germans nor any other people will submit to a prolonged period of hard times and unemployment, when the power of restoring business activity through a renewal of inflation is ready at hand.

Argument Against Deflation

There is another reason why a return to gold redemption of the existing currency will not—many students say, should not—be undertaken. The existing government debts have

[3] The railway operating deficit in 1921 was over 9 billion marks. Incidentally, these deficits would also make the payment of reparations impossible.

largely been contracted on the basis of highly inflated values. And to reduce prices, and hence money wages and profits, to a pre-war basis, or to anything approximating a pre-war basis, would enormously increase the difficulty of raising the necessary taxes. The point is that the interest on the public debt would not be reduced as the result of deflation, while the wages and profits out of which tax revenues must come would be reduced.

The following statement substantially as made by the Right Hon. R. McKenna, Chairman of the London Joint City and Midland Bank, will indicate what would be involved in deflation, even in England, where the price level now stands at only twice the pre-war figures: The two items of interest on the public debt, £350,000,000, and war pensions, £120,000,000, would, if prices and profits were reduced to a pre-war level, call for a tax of over 13 shillings in the pound, "a rate absolutely impossible for any country to bear." Thirteen shillings in the pound, it may be explained, means roughly 60 per cent of the national income. The other governmental revenue required would be additional to this. In Germany and France the difficulty would, of course, be intensified many fold.

If a deflation of prices and values back to pre-war levels should occur, it would be necessary to scale down in some way the public debts. This might be done either by repudiating them wholly or in part, or by reducing the rate of interest, paying in Germany, for example, perhaps the equivalent of one cent on the dollar. Such a proceeding is, however, beset with great political danger. It would arouse bitter opposition among certain groups. Human beings like to have taxes reduced; but they regard a scaling down of interest payments as a species of governmental robbery.

Even if the government debts could be scaled down, this would not end the difficulties. Private obligations of

stupendous amounts have been incurred since the currency became inflated. Corporations could not possibly pay interest and dividends on capitalizations contracted on the basis of values that obtained in Germany in 1920, if profits in terms of money were to be reduced, for example, tenfold. All private corporations would in consequence have either to scale down their interest charges by some device, or else reduce their outstanding bonds and shares. The attempt to undertake this would, of course, only serve to intensify business and financial uncertainty.

Stabilization of Present Prices

Considerations such as the foregoing have led many students of the situation to suggest that we should let bygones be bygones, and accept the present price and exchange level as a permanent fact. That is to say, they would stabilize the value of the mark, franc, etc., at approximately their present values and not attempt to go back to the pre-war gold parities.[4] The paper mark is now worth about one-twentieth of the gold mark—equivalent in American terminology to about 5 cents on the dollar; the franc is now worth about two-fifths of its normal value. Now to stabilize the currency at present values would require a rigid limitation of its quantity—a prevention of any further inflation.

Right here lies a practical impossibility—in most countries—of accomplishing the end in view. It is idle to talk of restricting further issues of paper currency so long as government budgets remain unbalanced. When taxes suffice only to meet a small percentage of government expenditures, the floating of government bonds soon becomes impossible and the issue of more paper money becomes the

[4] It is often argued, however, that some countries should first affect a substantial deflation.

only means of acquiring government funds. We do not need to go back to early European experiences, or even to American colonial history, to find striking illustrations of the difficulties in controlling the supply of paper money when once a nation is well advanced on the highroad of inflation. They may be drawn from the recent history of eastern Europe. [5]

The nations of central and eastern Europe are thus faced with a three-horned financial dilemma. To attempt a return to pre-war values and standards is fraught with the gravest industrial and social consequences, not to mention political results. Stabilization at existing levels is a practial impossibility, unless government budgets are first balanced, and government budgets cannot be balanced. Further inflation, the third horn of the dilemma, only leads to ultimate monetary collapse.

Continued Inflation Likely

What, then, is the probable outcome for Germany? Which of these equally disastrous roads will she seek to travel? All the evidence points towards the third—the pathway of continuous inflation. Business men are inclined to accept this course as the lesser of many evils. For, until the end comes—and most of them do not see the end—it means rising prices and good profits. It is, moreover, a stimulant to export trade; and Germany must increase her exports if she is to pay reparations. Some of the industrialists of France are also reconciled to this view of inflation.

That there is no present thought in German governmental circles of arresting further inflation is evident from a recent legislative enactment. In April, 1921, it was provided that the 33 per cent reserve requirement against

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[5] See further discussion of this problem in Chapter VIII.

bank notes should no longer be required.[6] It is accordingly now legal to expand the note issues indefinitely—to the point of worthlessness.[7]

The altogether probable drift in Germany will therefore be toward further inflation, rather than toward either deflation or stabilization. As has been the case in Austria and Russia, we may expect German currency to expand from 80[8] to 90 to 100 to 200 billions, and the value of the mark to decline from one cent, to a half cent—and ultimately to zero. No nation—it should be repeated—has ever been able to retrace its steps after its monetary system has once approached a condition comparable to that of Germany today. Repeatedly in history depreciation has continued gradually to utter worthlessness. The end usually comes when those having food or other necessities refuse longer to part with them for paper currency at any price.

Incidentally, paper currency in Austria is still not quite worthless. For example, a beer manufacturer uses paper crowns (kronen) as labels, existing kronen being cheaper than paper for the purpose; he thus advertises "kronen" beer. This will prove a short-lived opportunity, however, since it now costs about five crowns to manufacture a one-crown piece.

We have been saying "depreciation to zero" and "utter worthlessness." Perhaps it will not go quite to zero.

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[6] The reserve during the war was composed of gold and *darlehnkassenscheine*. The *darlehnkassenscheine* are the irredeemable promises to pay of certain German loan companies. Before the war the law required the Reichsbank to hold a gold reserve of outstanding notes of at least 33 per cent, but it was found expedient early in the war to modify this position and to permit the *darlehnkassenscheine* to constitute lawful reserve money.

[7] A bill was also recently introduced in France providing that the present limitation of 43 billions of note issues by the Bank of France be raised to 150 billions. We are informed that the measure has considerable backing.

[8] Within two months after writing the above the total note issues had increased to over 90 billions.

Before the point of utter worthlessness is reached the government may undertake some redemption scheme, whereby perhaps 100 marks in paper would be redeemed for one mark in gold. The effect would nevertheless be substantially the same.

Effects of Repudiation

There is little likelihood of outright repudiation of the mass of either German paper money or government bonds. Repudiation requires political courage; and courage is seldom an attribute of governments in financial distress. It is less difficult, and less painful, no doubt, to allow economic laws to accomplish in due season the same end that would be produced by political edicts.

What will happen to modern German industrial life if German currency goes the way of that of Austria and Russia? If the currency becomes worthless the government bonds issued in exchange for paper money must share a similar fate. What would be the economic result if a hundred billions of bonds and a hundred billions, or so, of currency should become utterly worthless? Would this mean starvation for millions of Germans, and political disintegration and bolshevism for the rest? No categorical answer can in the nature of things be given to such questions. That the industrial consequences of such an economic shock would be of unparalleled severity is not, however, to be questioned.

In one way this virtual repudiation of government bond and bank note obligation may be said to amount to little. For while the people would no longer receive interest, it would also be unnecessary for them to pay taxes. What they would lose—in interest—with their right hand, they would save—in taxes—with their left. But unfortunately, the matter is not so simple as that. As individuals we seldom pay taxes in precise proportion to the interest received on

government obligations; some pay more, some less, and some neither pay taxes nor receive interest. Accordingly, repudiation involves wholesale injustice to citizens and would result in a thorough-going redistribution of wealth, with accompanying widespread social disaffection. It is, therefore, the part of wiser statecraft to allow ultimate repudiation to come through the indirect process of inflation to the point of worthlessness.

Some idea of the economic consequences of this ultimate debacle may be gained if one considers that practically all of the collateral that is back of bank loans would be worthless; that the assets of savings banks and insurance companies—representing the savings of German citizens—would be wiped out; that the investments of the reserve and other funds of corporations would be destroyed; and that all private financial obligations of whatever sort would be automatically obsolete. The entire financial structure would collapse.

Development of New Credit Structure

Land, factories, equipment, railways, etc., would, however, remain. And since these constitute the primary foundations of wealth production, it is not to be supposed that a financial cataclysm would result in a complete cessation of economic activity. Nevertheless, all of modern economic life is organized and controlled through the financial machinery. Business is conducted in the midst of a complex system of established prices and values. A collapse of the entire financial mechanism would, therefore, result for a time at least, in nothing less than economic chaos.

Whether such an interregnum could be compassed without political and social revolution of the extreme variety is very doubtful. Mention has already been made of the redis-

tribution of wealth, and of the social disaffection that would result from government repudiation of bonds and paper currency. Indirect repudiation through the inflationary process might permit a particular government for the moment to escape responsibility, but in the end some government would be held accountable.

However disastrous to large masses of the population the first shock of the financial cataclysm would be, the nation would undoubtedly survive; and in spite of political upheavals, some day, no doubt, a new credit system based on the existing gold stock of the Reichsbank would be reared. Germany might eventually get started again on a sound money basis, that is to say, with new issues of paper money, redeemable in, and therefore as good as, gold. [9] On the basis of this new monetary system would gradually be developed a new credit structure, a new series of financial relationships, a new economic system. It should be understood, however, that, as in the case of ordinary bankruptcy, the past would remain the past—old values and claims would not be resurrected, not even the claims of foreigners to German paper marks, purchased in simple faith that Germany must and will come back. After bankruptcy present German obligations would be dead.

Thus stands the European monetary and banking situation at the present time. There is little hope that any of the nations east of the Rhine can return to sound money, save by the disastrous route of financial bankruptcy. West of the Rhine, the continental situation, if less desperate, is still

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[9] It might still transpire, however, that instead of issuing new currency that would be redeemable in gold, "new tenor" irredeemable notes would be issued as was in the case in American colonial days. Such a procedure would merely mean a repetition of the process of inflation to utter worthlessness. New tenor, however, seldom remains good for so long a period as the old or original tenor.

admittedly extremely difficult. The best that may reasonably be expected there is some effort toward stabilization at existing levels of monetary depreciation; but in view of the popular unwillingness to be taxed sufficiently to balance budgets and in view of the control that the masses possess over the fiscal policies of governments, there is little hope in this direction. In England, on the other hand, there is little cause for anxiety—provided only some measure of industrial peace and economic stability can shortly be attained.

CHAPTER VIII

CONCLUSIONS AS TO PRESENT EUROPEAN CONDITIONS

Formulating a Conclusion

We have completed the discussion of the several measures of European economic conditions—the foreign exchange, foreign trade, national debts, and national budgets, and the reserves of banking systems. It remains to draw together the different threads of the analysis and to formulate some general conclusion about the situation as a whole.

Can it be said that conditions are on the whole better, or are they worse than they were a year ago? The answer is not altogether simple. If, for example, one regards the condition of bank reserves and the degree of monetary inflation as the truest measure of fundamental economic conditions, he will doubtless conclude that the situation is now measurably improved so far as western Europe is concerned. Many people have based their conclusion that conditions are very much better now than they were twelve months ago, mainly on the improvement in bank reserves that has occurred. But, on the other hand, if one finds in the status of national budgets the clearest picture of economic conditions, he will doubtless conclude that the situation this year is appreciably worse than at any time hitherto. The meaning of the data presented in the preceding discussions is therefore still somewhat confused. Further analysis is necessary before a final judgment can be reached.

The significance of the data on national budgets, monetary inflation, foreign trade, and the foreign exchanges, may best be understood by considering the post-war era as one

composed of two distinct periods: (1) beginning in the spring of 1919 and continuing until the summer of 1920, there was a business boom that influenced the situation in certain definite ways; (2) beginning in the summer of 1920 and continuing without abatement to the present, we have been in the midst of a period of depression, which has produced results of a very different nature. It will serve to clarify the situation if we note the precise effects of each of these periods upon the condition of national budgets, monetary inflation, exchanges, and foreign trade. The statements which follow are based upon data assembled in preceding pages.

The Boom Period and Succeeding Depression

The boom period of 1919-1920 was accompanied by a great inflation of the currency and by rapidly mounting prices. During this period many students of economic conditions pointed out that the ultimate results of this process would prove disastrous and that the foundations of real prosperity were being undermined. From the monetary point of view the boom period was clearly unfortunate; the situation appeared to be growing rapidly worse. But during the depression of 1920-1921 there has been a substantial deflation of the currency in the United States and Great Britain, and at least a cessation of inflation in the continental countries of western Europe. From the monetary viewpoint the period of depression has therefore been beneficial; the situation appears to be steadily improving. But this is not true—it must be emphasized—as regards central and eastern Europe. And even in western Europe, only one form of inflation has ceased—that resulting from commercial or business borrowing. Government borrowings are as great, or greater, than ever.

Can we conclude from this—as many have concluded—that commercial deflation is indicative of fundamental im-

provement in European economic conditions? The trend of trade and production will throw some light upon the issue involved. During the boom period of 1919 and 1920, foreign trade and the volume of production expanded—in physical quantity as well as in values. It was during this period, it will be recalled, that the commercial press and the financial community alike were proclaiming to the world in the most extravagant language the marvelous rapidity with which Europe was coming back. England could boast of her rapidly increasing output and expanding foreign commerce; France could congratulate herself over the phenomenal progress that had been made in restoring her devastated areas; and plucky Belgium could point with honest pride to her unparalleled industrial and commercial achievements.

There were flies in the ointment, it is true, even aside from the perils of inflation. Labor and management were inefficient. Industrial warfare was a perpetual menace. Extravagant consumption and inordinate waste were universal phenomena. Basic industries, such as transportation, public utilities, and housing, were neglected. And the rapidly mounting prices were responsible for much of the social and political unrest which characterized the entire period. But wealth production in Europe nevertheless increased. The figures of expanding foreign trade show it, as do also the statistics of domestic production in the several countries.

But beginning with the deflation period of 1920–1921, Europe can boast only of improving banking conditions; and not all countries, as we have seen, can even do this. Production—save in agriculture—is steadily declining, unemployment is becoming a world menace, and foreign and domestic trade alike are languishing. The price of the boom period of 1919-1920 was inflation; the price of the deflation and depression period of 1920-1921 is, thus far at least, reduced production and lowered standards of living.

Foreign Exchange as an Index

Viewed from the angle of the foreign exchanges, however, we do not find such distinct differences in the two periods under consideration. With one exception, foreign exchange rates are, as we have seen, lower at this period of 1921 than they were a year ago. But the period of business depression has not resulted in a sharp decline of foreign exchange quotations, for a variety of reasons. So far as the bills of exchange which arise out of actual trade operations are concerned, the depression cannot be said to have increased the disproportion between supply and demand. Indeed, in the case of France, as we have seen, the collapse of American exports to France has served materially to reduce the supply of bills and has thus tended to raise French exchange rates.

A similar influence has been in evidence in all Europe. The large exports of gold to the United States in recent months, while bad, very bad, from the point of view of long-run international financial readjustment, has nevertheless temporarily helped to stiffen exchange rates. At the same time the large American tourist travel abroad has tended to the same end through increasing the demand for foreign money. These factors, together with the sentimental effects of the reparations settlement upon Allied finances, explain why French exchange is slightly higher than a year ago and why other Allied exchanges have not fallen more than they have. On the whole we must conclude that the movement of exchange rates during the past year throws very little light upon fundamental conditions abroad.

Burden of National Debt

The condition of national budgets is also interestingly related to the two different periods in question. During the boom year, while government expenditures increased in

most countries, the inordinate profits of business made it possible also to increase the revenues from taxation. Although the situation was anything but satisfactory, the view was widely held in the early months of 1920 that if government expenses were restricted through the institution of rigid economy and if taxes were courageously increased, European governmental finances would soon be on the highroad to recovery. As a matter of fact, however, the result of depression in every country has been to reduce enormously the profits of business, and in consequence, to reduce the government receipts from existing taxes. On the other hand, the depression has tended to increase expenditures through enlarging the requirements for unemployment insurance.

It appears to be a practical impossibility for any nation greatly to reduce expenditures this year—and this will remain true so long as the depression lasts. Therefore, national budgets in Europe are likely to go from bad to worse. The burden of national debt will be rapidly augmented; that most pernicious type of inflation, namely, the kind that results from government or bank issues of paper money for non-productive purposes, will be steadily increased, and in consequence the whole economic organization will progressively deteriorate.

The conclusion, therefore, seems definitely to be that, all things considered, the European economic situation is today worse—substantially worse—than a year ago. The basic requirement is always increased production; wealth that has not been produced cannot be consumed. Reduced wealth production means inevitably reduced standards of living; and reduced standards of living mean social deterioration.

The improvement in banking conditions—in some countries—cannot be said to weigh heavily against the factors of deterioration which we have been considering. In

this connection it is of interest to observe that the two countries of Europe that now boast of the least disturbed trade conditions, namely, Italy and Germany, are the nations in which commercial inflation has been least checked; while the nations that are most distressed are the ones in which deflation has been the most pronounced.

Let there be no misunderstanding in this connection. It is not for a moment being contended that the inflation of last year was desirable or that it should not have been checked. For the boom of 1919-1920 was not laying the foundation for continued economic prosperity. The increased production was too largely in non-essential or relatively unimportant lines of enterprise. Fundamental industries, as we have seen, were being neglected. Moreover, continuation of the process of inflation could ultimately lead only to financial disaster. What is contended for here is merely that deflation has not yet brought any tangible measure of economic recovery to stricken Europe.

Intangible Results

But what of the intangible results? Is not the period of deflation a blessing in disguise? Are we not thereby gradually proceeding toward a condition from which a genuine and constructive economic revival may be started? Did the situation not have to become worse than it was before it could become better than it is? In fine, are we not now rapidly passing through the period of deflation and are not brighter skies immediately ahead?

It is undeniable that deflation was a necessary prelude to better days; and it is equally undeniable that deflation could not be accomplished without an interregnum of business depression, more or less severe. There are those who believe that it has been much more severe than is necessary, that it might have been controlled and made at once more

gradual and less disturbing to business operations. Others doubt the possibility of controlling world-wide deflation any better than it has been controlled on this occasion. But be this as it may, it is agreed that some measure of business depression was inevitable before prices and finances could be readjusted to a basis from which prosperity could once again be started on firmer foundations.

If, therefore, there was assurance that the depression would now soon be over, it might indeed be concluded that the situation is now very much better than it was twelve months ago. But is there any sound reason for believing that we have reached the bottom of depression, and that having reached the bottom we shall shortly begin a new ascent to business prosperity? Of such paramount importance is this issue to any trustworthy conclusion as to the economic condition of Europe today, that it requires more than a passing comment; we must, indeed, devote an entire chapter, the one following, to the consideration of this subject.

Subsidence of Industrial Unrest

It is often argued that the social neurasthenia of the early post-Armistice period has now passed away and that neither economic nor political unrest any longer constitutes a serious menace to European recovery. It is undoubtedly true that in many countries labor has been placed upon the defensive by the events of the past year; and it is also true that the chances of political upheaval are at the moment decidedly less than they were last year or the year before. One cannot for a moment seek to underestimate the importance of the change in popular psychology that has occurred. Labor is more inclined—speaking generally—to work hard for its daily sustenance than last year; and less inclined to industrial turmoil. So far so good; but the good would be

much better if so many millions were not now denied the opportunity to work.

The fact must not be overlooked that in central and eastern Europe, without considering Russia, industrial unrest has been held in check only by the process of granting all demands for wage advances. In lesser degree this has also been true in western Europe. Nowhere—except in England—has any real effort thus far been made to shoulder the real burdens of war costs. Industrial and political unrest is only in abeyance. It is necessary, however, to let the issue rest for the moment at this point. We shall return to it after considering the probable duration of the business depression.

Agricultural Conditions

But, it may be asked, has not agriculture shown substantial improvement? And, if it be true that the basic industry of all is making steady progress, does it not follow that fundamental economic conditions in Europe are now on the mend?

It is true that another improvement in European conditions is found in agriculture. There is no question but that throughout Europe food production increased in 1920 as compared with 1919, while in some regions there has been further improvement in 1921. According to a member of the Reparations Commission, in the new countries of eastern Europe agricultural conditions were materially better in the spring of 1921 than the year before. The Hoover Relief Organization has found similar improvement.

Another communication from the European representative of the Rockefeller Foundation indicates that health conditions are, in consequence, also materially improved. For the first time since the war the birth rate this year exceeds the death rate.

It was to be expected, of course, that agriculture should be the first industry to improve. For it is free from the labor and other troubles which beset the industries of urban communities, and it is less definitely involved in the complex web of financial relations that make up the modern monetary system. And most important of all, it is little affected by industrial depression—that is, so far as volume of output is concerned. Agricultural production goes on regardless of the business cycle.

French Crops

But, on the other hand, agriculture is peculiarly affected by weather conditions. The relatively good showing of the year 1920 is in no small degree attributable to the generally favorable weather conditions that prevailed in Europe. This year, on the other hand, large sections of Europe have suffered from one of the worst droughts ever known. As everyone knows, it has brought starvation to millions of people in the Volga valley; and it has greatly reduced the agricultural output in all of western Europe. The following indexes of crop conditions in France made public on July 5, 1921, by the Department of Agriculture are significant. The figures are percentages of 100, which means "very good." [1]

	June 1, 1920	June 1, 1921
Meadows	76	64
Sugar beets	77	71
Corn	70	71
Potatoes	74	69
Vineyards	75	59

Since the drought continued until the third week of July and was then broken by violent storms which inflicted much

[1] Federal Reserve Bulletin, August, 1921, page 956.

damage to crops in southern France, it is altogether probable that the final yields will prove even more disappointing than the June 1 estimates indicate. While no official estimates are given for wheat and the other cereals, it appears from current reports that the damage to these was not so great.

The results of the severe droughts this year may be glimpsed from the fact that the Hoover Relief Organization has this summer again been obliged to render aid in the devastated areas of northern France.

French agriculture may be taken as typical of the best in Europe. Hence, the following comparative data on the yield of leading crops in France before and since the war will prove illuminating: [2]

(In quintaux, 000 omitted)

	1913	1919	1920	1920 crops as compared with 1913=100
Wheat	86,919	49,654	64,482	74
Rye	12,715	7,299	8,761	69
Barley	10,438	5,000	8,357	80
Oats	51,826	24,536	42,208	81
Corn	5,431	2,534	3,878	71
Potatoes	135,860	77,305	116,378	86

The good year, 1920, showed a marked improvement over 1919; but on the average food production was still only about three-quarters that of 1913. This year it will be even less. Potatoes made the best showing in 1920; but the figures in this case include the production of Alsace-Lorraine.

The following table shows the number of farm animals in France in 1919 and 1920 as compared with 1913: [3]

[2] Federal Reserve Bulletin, August, 1921, page 956.
[3] *Ibid.*

(000 omitted)

	1913	1919	1920	1920 as compared with 1913=100
Cows and beeves	14,788	12,374	13,217	89
Horses	3,222	2,413	2,635	82
Mules	188	167	181	96
Asses	356	303	298	84
Sheep	16,131	8,991	9,406	58
Hogs	7,036	4,080	4,942	70

In final conclusion it may be said that the temporary alleviation of industrial unrest and the slight improvement in agriculture that has occurred do not weigh heavily in comparison with the other indexes of fundamental conditions which have been considered. Foreign exchange and foreign trade, monetary inflation and government finances, are the controlling factors in the highly complex and interdependent financial organization of the twentieth century.

CHAPTER IX

HOW LONG WILL THE DEPRESSION ENDURE?

Divergent Views

The duration of the business depression which now holds the world in its thrall is conceded to be one of the most vital economic—and political—issues in the world today. It is a paramount economic issue because upon business recovery depends the material well-being, one may almost say the very existence, of many millions of people. It is a paramount political issue because without a return of prosperity many existing European governments will sooner or later succumb under the financial strain to which they are now being subjected. In view of the enormous significance of the problem, a thorough-going analysis of the factors involved in the present industrial and financial situation is required.

Men's views of the probable duration of the present depression in business are as far apart as the poles. Among those who count themselves shrewd judges of economic conditions there is the greatest diversity of opinion. Some are convinced that we are in for many years of depression; others hold that a year from this autumn will see a turn for the better; while still others insist that a substantial improvement is due within a few months. It will serve as a useful background to our analysis if we first present the arguments advanced by those who hold such divergent views as to the probable duration of the existing depression.

Those who look for an early revival of business base their conclusions on a variety of grounds. Some contend that prosperity will return the moment the buyers' strike is

ended; let purchasing be resumed and all things else will follow. Others are less specific and merely feel that all will be well as soon as the world as a whole has settled down to "normalcy." Others insist that it is mainly a question of interest rates; when money again becomes cheap—not long hence—loans will be increased and business activity will revive. Still another view is that production has been reduced much more than consumption and that exhausted stocks of goods will shortly necessitate a resumption of productive activities. Finally, there is the "ordinary business cycle" view which holds that the history of past trade cycles indicates that the duration of depression is normally short, that the bottom is soon reached, and that the process of recovery then presently begins.

Buyers' Strike Theory

One finds, by reference to contemporary literature, that the buyers' strike argument is heard less frequently now than it was a year ago. It is beginning to be realized that the failure to buy—whatever may have been the case in the early stages of the depression—is now largely due to a lack of buying ability. The huge volume of unemployment and the reduction of wages and profits has destroyed purchasing power; and it is urged that it cannot be restored until after active business has been resumed. Credit has also been undermined, particularly in Europe. Thus many insist that the United States must resume credit extensions to Europe before the purchasing of American raw materials can be resumed.[1] Following this development, it is urged that the buying power thus generated among the producers of foodstuffs and raw materials in the United States will soon produce a general revival of domestic prosperity there. Those

[1] The problems involved in resuming foreign credit extensions are discussed in Chapter XIX.

who hold this view are, however, not hopeful of an early revival; they are looking a good many months ahead, for they realize the difficulties involved in resuming credit extension to Europe under present conditions.

Cheap Money Doctrine

Those who insist that as soon as "cheap money" is attained business men will again seek to borrow from the banks, loans will be increased, prices will rise, and prosperity will be resumed, argue, one must say, from premises which find little, if any, support in actual business life. This point of view requires more than a passing word, however, because, strangely enough, it is tenaciously held by many economists of the present day.

There is an old argument to the effect that when anything is cheap the demand for it automatically increases; and it would seem to follow that when money is cheap the demand for it will also increase, with the results suggested above. So certain are some economists that the whole problem of depression is but a simple question of interest rates, that they attack the managers of the central banks of England and the United States for not summarily reducing discount rates for the purpose of breaking the back of the depression. But one may learn from the experience of business men that there is no reason whatever why a business man should seek to borrow money at 4, or even at 1 per cent, if he cannot find an opportunity to employ it at a profit. Moreover, in a time of depression the security for loans is scrutinized by bankers with more than ordinary care and they will not grant a loan for commercial purposes at all unless they "see the money coming back"—as a result of profitable business operations.

If evidence on this point is wanted, it is to be found in abundance in the history of some of our past depressions,

notably in the early nineties and in the late seventies. In the latter period there was a plethora of funds and "rock bottom" interest rates in the United States almost continuously from the autumn of 1873 to the summer of 1879. Bankers complained of their inability to loan money; and many threatened to leave the business because it had ceased to be profitable. Conditions were similar in other countries. In the seventies and nineties the discount rate at the Bank of England fell as low as 2 per cent without stimulating a revival of borrowing. Instead of wishing to borrow, many businesses sometimes find it impossible in a time of depression to make a profitable use of all of their own working capital; they also have money to lend.

In the face of these facts, which he who runs may read, it is nothing short of a psychological phenomenon that so many students of finance should hold to the myth that low interest rates alone are sufficient to produce a business revival. The truth is that cheap money is one factor conducive to a revival of business activity; but it is only one of many which must act together to restore the confidence that is necessary to business resumption.

Exhausted Stocks Theory

The contention that production has decreased more rapidly than consumption and that, in consequence, increased production will shortly be required, has more point to it. If stocks of goods are being rapidly depleted and if the volume of consumptive demand is above current production, it would seem to follow that sooner or later production will have to be increased.

It does not necessarily follow, however, that on the present occasion an early return of prosperity is, for this reason, assured. In a number of lines accumulated supplies appear already to have been exhausted; but the increased

output that resulted from this depletion was not great, for the reason that so many other lines of business were still "on the way down." In many basic industries, moreover, it is notorious that the supplies of goods are still of huge proportion. With 16,000 hogsheads of tobacco (two years' supply for Great Britain) in Liverpool warehouses; with nearly three years' world supply of wool on hand; with hides almost unsalable at any price; and with large supplies of sugar, copper, cotton, and other commodities still on hand, one has to have even more than the natural American gift of optimism to look for a substantial revival of production in the near future in these basic lines.

It is not without significance, moreover, that there are vast stocks of war supplies which governments must still liquidate. It is understood that the United States government alone has several billion dollars' worth of supplies still unsold—supplies of almost every conceivable kind. It is understood, also, that the government is hesitating to sell them at this time through fear of the demoralizing effects upon the markets generally. Granted that the argument that production must ultimately be increased to catch up with consumption is sound, there is nevertheless little ground for believing that the time has yet arrived. More will be said in this connection presently.

The Question of Prices

Closely associated with the argument just considered is the contention that after prices hit bottom in any line, they must soon thereafter begin to rise again. Accordingly, even before all prices get to the bottom, there may be enough that are already coming back to make the net situation one of improvement. But is it true that when prices reach bottom in any line they necessarily start going up again, and that in consequence when the "price bottom" in general has been

reached there will be an early recovery of business in general?

Whatever may have been the case in some periods of minor depression, it was certainly not true in the major depressions of the early nineties and the late seventies that prices rebounded immediately after reaching the cellar. In fact they remained down—with minor fluctuations—for several years; they even descended to the sub-cellar. The events of these depressions should also prove disquieting to those who insist that production will necessarily increase just as soon as stocks are depleted.

While on this argument, it may be well to ask precisely what is bottom in the present price situation? Will the bottom be reached when prices are only 50 per cent higher than before the war, or will the index number go down to 125, or, perchance, will it go all the way back to, or possibly even below, the level of 1913? The views of most students of price movements have already had to be revised several times during the present decline. May they not have to be revised again? It is significant that the number of students who believe that prices may conceivably fall to the pre-war level—at least in England and this country—is increasing.

But, it may be asked, how is such a decline possible in view of present costs of production? The answer is that costs fall as prices decline. There is, in fact, an interaction of forces; a decline in costs—for any reason—permits a cutting of prices; and a cutting of prices below cost, as often occurs, forces a driving down of costs. The vicious spiral that characterized the period of rising prices has been reversed; the corkscrew is now boring downward.

Further Decline Likely

Notwithstanding the cessation of price declines in England and the United States during the summer of 1921, there

is little reason to believe that the decline has been permanently halted. The depression in some countries is just getting under way, and this will have its effects in the international markets generally. Germany is making a desperate effort to acquire funds for making reparations payments, by underselling her competitors in every market. Great Britain is making a tremendously powerful drive for a reduction of wages in all lines, to the end that she may regain her place in world markets—a place that a few years ago she had been able to maintain only because of the very low price of coal. Whatever may be the merits of the effort, success is at last attending British efforts to liquidate labor. The cumulative effects of the recent reductions in British wages upon the money costs of production in British industry generally will not be fully manifested for many months.

In the United States, also, there is little reason to believe that the end of the descending spiral has been reached. The process of wage-cutting, for example, still continues. Indictments of the "criminals" engaged in building trade combines are—according to reports—still in an incipient stage; and coal prices have not as yet been materially reduced. More significant still is the powerful drive that has recently been started for a reduction in transportation costs. It may take a long time to accomplish this reduction; but before we are through with the process of liquidation, railroad rates will be materially lower—following which, there is practically certain to be another wave of cost and price reductions more or less throughout the industrial system.

In this connection, it may be noted, that those who hold to the buyers' strike view of depression can find little reason for immediate optimism. For, so long as there is a hope that the forces at work will carry prices still lower, there is little incentive to resume purchasing just yet. The buyer is no more certain to regard 50 per cent above pre-war prices as

bottom than 100 per cent above. He is more likely to see the bottom as actual pre-war prices. In so far, therefore, as psychology may affect the situation, its influence will be in the direction of still further price declines. Little stock is to be taken in the psychological argument, however; the history of past business cycles reveals that changes in psychology follow rather than precede changes in fundamental business conditions.

Price Maladjustment

Altogether too much emphasis has been placed upon the average of prices, as revealed in the various index numbers. The important matter in the present situation is not that the average price level is now only 50 per cent higher in the United States, for example, than it was in 1913; not the average of all prices, but the variation of prices as between different groups of commodities is the significant feature in the present price situation. The prices of agricultural commodities in the United States, taken as a group, as shown by the United States Bureau of Labor Statistics, now average about 13 per cent higher than the 1913 figures. It should be added that these are the prices in the primary markets, and not at the farms, where prices are now little, if any, above actual pre-war levels. On the other hand, the prices of household furnishings are still approximately 2½ times the pre-war prices, and the prices of building materials are approximately double those of 1913. A number of other groups of commodities are still well in excess of 50 per cent above the pre-war level.

Now the farming communities in the United States still comprise over one-third of the total population. Accordingly, the purchasing power of the farmers is of fundamental importance to industrial prosperity. With the prices of the things which the farmer has to sell roughly at pre-war levels

and the prices of the things which he has to buy still roughly twice the pre-war prices, it requires no great mathematical ability to demonstrate that farm purchasing power has been tremendously reduced because of the disproportionately heavy fall in the prices of agricultural produce. Before the war the gradual evolution of agriculture and industry had resulted in a normal price equilibrium, which passed away when widely different changes took place in prices.

The present unbalanced situation will remain true until one or the other of two things happens: Either farm prices must rise until they approach an equilibrium with the prices of other things, or else the prices of other things must fall until they approach an equilibrium with farm prices. There are those who argue that the easy way out is to raise farm prices half-way and reduce the prices of other things half-way, thereby effecting an equilibrium at a level of, say, 50 per cent above the pre-war average. Nothing, however, in the working of economic forces can be found to justify the belief that the prices of agricultural produce can automatically be raised with a view to reaching the desired equilibrium. The prices of agricultural commodities in the United States and elsewhere will be governed by world-wide conditions of demand and supply, and there is nothing in the present situation to warrant any confident belief that the prices of agricultural commodities will soon rise much above their present levels. If such proves to be the case—if agricultural prices remain at or near their present levels—the resulting low purchasing power among the farmers of the world will in the end drag the prices of the other groups of commodities down close to the same level. A lagging demand for the products of manufacturing industry throughout the vast agricultural areas of the country will exert a persistent pressure for a continuance of the process of industrial and labor liquidation.

Price Stabilization

There is a widespread agitation at the present time, both in the United States and Europe, in favor of the stabilization of prices at approximately their present level. It is urged that further deflation is highly undesirable because of the attending industrial consequences; deflation, it is contended, is just as bad as inflation. Neither high nor low prices matter; all that matters is that prices should cease to fluctuate.

The whole argument for price stabilization, however, rests on the assumption that it is the price level that is the significant factor in the present price situation. The argument wholly ignores the wide variations that now exist in the prices of different groups of commodities. No attempt can here be made to discuss fully the issues involved in the stabilization program. Two or three questions may, however, with pertinence, be raised.

If possible, would it be desirable to stabilize prices at a level of 150, when such action would involve holding the prices of farm products at approximately their present low levels and the prices of household furnishings, building materials, etc., at approximately their present high levels? Is it possible, if agricultural prices remain at their present levels, to maintain the prices of the things which the farmer has to buy at their existing levels? Is it possible to have the prosperity which "stabilizers" hope to promote, by keeping agricultural purchasing power permanently depressed? If not, how, concretely, is it proposed to eliminate automatically the wide price divergencies that now exist?

The Quantity Theory of Money

There are numerous economists of standing who argue that prices cannot be expected to fall any lower than they now are because of the vast quantity of gold and paper

money that is available for the requirements of business. The quantity theory of money implies that the level of prices is controlled by the quantity of gold and other forms of currency, including credit or deposit currency. If this theory is sound, the question naturally arises whether it is not true that the present quantity of currency is easily sufficient to support the present level of prices throughout the world.

In the long run, there is undoubtedly a fairly close correlation between price movements and changes in the quantity of gold and other forms of currency. In the short run, however—that is to say, in the downward swing of the business cycle—it cannot be said that the quantity of gold and credit currency is of any real importance. While a shortage of currency and of bank reserves may limit the extent to which prices may rise on the upward swing of the cycle, a plethora of funds does not limit the extent to which prices may fall during the period of depression.

It may be recalled in this connection that certain strong adherents of the quantity theory urged a year or so ago that prices could not fall at all, because the quantity of currency in circulation would not permit it. The post-war price level was necessarily to be permanent. After the index number of prices in the United States had fallen from the peak of 272 to 225, it was then argued by many that prices could not well go below 200, because the quantity of gold and other forms of currency was sufficient easily to support a price level double that of 1913. And now that prices have receded to an average of 150, these same persons are still sure that the supply of currency is the controlling factor, and that in consequence prices cannot well go much lower.

The fact is that the downward movement of prices is governed by a tangled web of economic forces, in which the quantity of money and currency plays a relatively unim-

portant rôle. The quantity of currency in circulation has decreased, it is true, but only after the fall in prices and the decrease in the volume of business activity. Prices actually fell for several months before the decline in currency began. Currency that last year and the year before was in the channels of circulation is now, in consequence of the prolonged liquidation that has occurred, accumulated in the vaults of banking institutions. There appears to be no reason why, so far as the currency supply is concerned, the price level may not as readily decline from 150 to 125 as it did from 200 to 150. The result would merely be a still further augmentation of bank reserves.

The only way in which the accumulation of bank reserves, resulting from the decline in prices and the business depression, may conceivably serve to check further price declines, is through the effects of a plethora of funds upon discount rates at the banks. As we have already seen, however, low interest rates alone cannot check the forces of liquidation nor bring about a resumption of business activity.

On the next upward swing of the business cycle the existence of very large bank reserves, and the great powers of credit expansion on the basis thereof, will undoubtedly permit prices to rise again for some time and to a very considerable extent. Thus in the long run—particularly if the nations of Europe do not attempt to reduce outstanding currency in the effort to return to a specie basis—we might have a price level very much higher than that of 1913. For the present, however, we are concerned with the possibilities of a still further decline in prices during the present downward swing. On this issue our conclusion is that the available supplies of gold and other forms of currency will not prevent still further price recessions. The extent of the fall will be governed by other factors.

The "Ordinary Business Cycle" Theory

This theory of the "ordinary business cycle," the advocates of which look for an early return of moderately good business, merits careful consideration. A study of business and financial data over a period of years reveals a very definite cycle movement. Business passes successively through stages of depression to prosperity, to financial crisis and back to depression, whence in due time it emerges again and enters upon a new round of prosperity, etc. This cyclical movement has, of course, been long observed, but until lately the stage of depression was generally regarded as of somewhat uncertain duration. But recent elaborate statistical correlation of financial and business data has led certain economists to conclude that depressions are normally of fairly uniform duration.

The study on which this conclusion was based covers the years from 1903 to 1914, during which there were four periods of depression. It was found that from the date on which interest rates ceased advancing on the upward swing of the business cycle, it was always from six to ten months, usually nearer the latter, before the bottom of the depression was reached and a turn for the better was definitely discernible. This correlation method, it should be understood, does not attempt to assign causes; it merely ascertains the facts. The significant fact is that, for some reason or other—it does not matter what—a business depression works its own cure in from six to ten months.

The theory is, nevertheless, pretty closely associated in the minds of economists with the low interest rate theory already discussed. Since interest rates ceased to advance in the summer of 1920, it was predicted that the bottom of the depression would be reached in the spring, say April, of 1921. Events have already shown that the date was set too early. Indeed, it has been conclusively demonstrated that

the length of time required to reach bottom under present conditions bears no relation to the length of time required under conditions which prevailed in other depressions. It remains to be seen whether, when the bottom is reached, a new ascent will immediately be begun.

Untenable Doctrine

The fundamental difficulty with this theory as applied to the present situation is, in brief, that the data on which it is based were drawn from a period (1903-1914) when world economic conditions were the most stable in history —a period relatively free from destructive wars, one during which all important nations were on a well-established gold money basis, with the international exchanges almost everywhere at par, and the whole international financial and trade mechanism in adjusted equilibrium. It was a period in which public finance in all leading countries was on a sound basis, with revenues sufficient to care for expenditures. It was, moreover, a period in which the prices of different groups of commodities were in rough equilibrium; there was at no time any violent dispersion of prices as between the various groups of commodities.

Now the data drawn from such a period are in this theory used to predict the duration of a business depression in the present era when conditions are utterly different—when domestic prices in basic groups of commodities have been thrown completely out of adjustment, when the disruption of the world-wide international financial mechanism is without a parallel in history, when unbalanced national budgets imperil the very existence of present governments; in short, when the foundations of organized society have been shaken.

We must clearly abandon the doctrine that the normal duration of a business depression is always from six to ten

months. We abandon it the more confidently in view of the known facts as to the duration of some of our earlier depressions. In the early nineties and the late seventies, as we have already seen, the "ordinary" duration was not from six to ten months; these depressions were of several years' duration. There were in each case minor—very minor—fluctuations in trade during the period of the depression; but there was nothing resembling a sustained revival for practically six years in the seventies and for four years in the nineties.

We do not refer to these earlier depressions for the purpose of proving that the present depression will necessarily last for either four or six years. Although conditions during the depression following the crisis of 1873 resemble those of the present more than they do those of any of the minor depressions between 1903 and 1914, one would not be warranted in insisting that the parallel is close or that much may be inferred from the duration of the depression of the seventies. A brief description of the conditions obtaining during the latter years of this depression and of the forces which appear ultimately to have conspired to restore prosperity will, however, prove suggestive.

Depression of 1873-1879

For several years during the depression of 1873-1879 interest rates, as we have already seen, were low; labor was thoroughly liquidated; and prices were down to "rock bottom" although not altogether in equilibrium. But the situation did not work its own cure. Purchasing was not resumed and prices did not start upward immediately after what everyone regarded as the bottom had been reached. Neither psychology nor the play of "natural" economic forces sufficed to bring a resumption of prosperity. Business remained in the doldrums.

What was it that ultimately broke the back of the depression in the summer of 1879? The early months of that year had not been promising. Very much depended upon the condition of agriculture. The outlook for the wheat crop was, however, mediocre, and the prospect for a favorable price distinctly poor. The year 1878 had produced one of the largest European wheat harvests on record. "When 1879 was well advanced, wheat from the English farms was still moving in quantity to storage points; at the close of March the stock of wheat at Liverpool was larger than at any time within five years." [2] (At this period, it should be understood, Europe ordinarily still produced grain for export.) Accordingly, the American prospect was anything but encouraging. Given a reasonably good European crop, a further depression in American wheat prices seemed inevitable.

In the spring and early summer, however, there developed in England the most untoward weather "known to the memory of living man." Extreme cold, accompanied by continuous rain through the harvest season, made the wheat crop almost a complete failure. Conditions on the continent were not very much better. The result was an unprecedented demand from Europe for American wheat. At the same time there developed in the United States extraordinarily favorable crop conditions, with the result that the American wheat yield in 1879 broke all existing records and was not again equaled until 1891. The combination of a huge crop and a high price brought an increased purchasing power to every rural community in the grain growing sections of the country. The resulting demands for goods were soon manifest throughout the industrial systems.

Other events, largely fortuitous, combined to lay the

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[2] Alexander D. Noyes, "Forty Years of American Finance," page 53.

foundation for a remarkable revival of purchasing power in the autumn of 1879. Noyes tells us that: [3]

"The crop of Indian corn was the largest on record; this, too, found a ready and profitable export market. Cattle raised on the interior farms were sent abroad in such numbers that the foreign trade complained that British graziers were being forced out of the British market. By a rather remarkable coincidence, the famous tide-water pipe-line from the Pennsylvania oil-wells was completed in 1879, and the year's export of this product rose nearly 2 million barrels over the highest previous record. By another coincidence, equally independent of any events already noticed, the cotton crop of India in 1879 was a partial failure; Europe's supply on hand fell off 30 per cent from the autumn stock of 1878 and 50 per cent from 1877, and with the consequent heavy purchases by foreign spinners, the season's export of American cotton was the largest ever yet recorded."

The situation at this time was complicated by a monetary problem. The resumption of specie payments, i.e., the redemption of greenbacks in gold, occurred on January 1, 1879. The confidence resulting from a return to sound money was not sufficient, however, to restore prosperity, as is shown by the persistence of the depression throughout the first half of 1879. Indeed, if it had not been for the unexpected expansion of exports that occurred and the resulting inflow of gold from Europe, there is little doubt that the attempt to resume specie payments would have proved a failure.

It was thus a remarkable concatenation of events—largely fortuitous—that broke the back of the long depression of the seventies. No doubt the drastic liquidation that

[3] Alexander D. Noyes, "Forty Years of American Finance," pages 56, 57.

had occurred, with the resulting low interest rates, low wages, low prices of basic raw materials, together with a plentiful and willing supply of labor, were factors conducive to a business revival. But taken alone, they had proved insufficient to restore prosperity. Orders on the books were still lacking—consumptive demand was everywhere lagging. Hence industry continued to languish until the wheel of fortune gave the necessary fillip to demand.

Chance Developments and Recovery

To guard against misinterpretation it must be reiterated that these events of the depression of the late seventies are cited only for the light they throw upon the current theory that business depressions always work their own cure within a short period of time. We do not conclude from the analysis that the present depression will necessarily last several years. Indeed, we do not pretend to know how long the present depression will last. We incline to the view, however, that the process of liquidation is still far from completed, and that the economic retrogression of Europe is a very definitely bearish factor in the whole industrial outlook.

In general, we believe that whatever may be true of the lesser oscillations of business, a major depression is normally broken only by chance developments. It is possible, therefore, that some fortuitous chain of events, which no one can now foresee, will bring us out of the present depression at a relatively early date. But if we are to face facts and weigh the possibilities of an early recovery of economic prosperity in the United States and in Europe, it is important that we disillusion ourselves of the notion that business depression cannot last more than a few months or a year or so at the most. The lesson of the depression of 1873-1879 is that after the bottom has been reached it is possible for business to stay in the doldrums for a long

period of time. The industrial machine may remain, as it were, at dead center.

Before closing this discussion of the probable duration of the business depression, it should be stated that few among those who believe that the bottom of the present depression has been reached—that liquidation has now run its course—contend that a period of great prosperity is at hand. What they urge is merely that the worst is over; that conditions may be expected to show a slight improvement in the near future, and that gradually they will materially improve. Most of them concede that there is still a rocky road to travel.

Most but not all. There are some—not economists—who still contend that the great need for goods resulting from five years of unprecedented destruction of wealth must shortly raise both Europe and the United States out of the existing depression. Housing is everywhere in arrears; railroads and public utilities have not been rehabilitated; the capital goods generally that were destroyed during the war have not been replaced. Never in the history of the world was there so great a need of intensive industrial activity as now.

Lack of Effective Demand

All this is only too true. But it does not follow that the mere need for wealth will result in its production. The construction of additional houses and factories, and the rehabilitation of railroads will, under a profit-making system, be undertaken only when it pays to do so. In the language of economists, there must be not merely a need; there must also be an effective demand—that is to say, demand backed by the ability to buy. Poland needs houses; but the Polish people cannot now pay cash for the food required, let alone houses. Austria needs raw materials;

but the Austrians are starving, and they must mortgage their future because they have no means of paying for raw materials. And the sad part of it all is that many of these people will not be in a position to buy even food until some measure of industrial prosperity has returned. France and Belgium and Germany and Italy likewise need houses and railroads, factories and equipment—what not—after the terrible destruction of four years' war. But the rank and file of the people who alone can furnish the demand for these goods have not now the purchasing power with which to buy them. And they will not have until something again starts the wheels of industry and again furnishes them with remunerative employment.

Such building as has occurred since the Armistice in any of the European countries—even in England—has in the main been subsidized building. The effects of subsidies upon government finances have already been indicated. Nowhere in Europe has it been demonstrated that there is an effective demand for building. While the situation in the United States is very much better in this respect, there are few who seriously contend that our rent problems and construction problems have been definitely settled.

In conclusion, it must be understood that in all the foregoing analysis we have been speaking only of the situation as it may develop if allowed to run its natural course, free from governmental or other organized intervention. There is here suggested, of course, the possibility of credit extensions to Europe as a means of giving the initial impetus to a resumption of purchases. Since further credit extension, however, involves political as well as economic considerations, on the question of reparations and inter-Allied debts, as well as industrial phenomena, its discussion must for the present be postponed.

CHAPTER X

ECONOMIC AND SOCIAL DISINTEGRATION

Time as a Healer

There is a widespread impression that time is the great, indeed the only, healer. Notwithstanding the fact that nearly three years after the war European conditions are on the whole worse than ever, there are those who still count upon the mere lapse of time to effect an ultimate restoration of the shattered economic organization. Have not nations in the past always recovered from the ravages of war? Is not the march of civilization always onward?

The simple truth seems to be that time has not always wrought the precise cure which the doctors have desired. Something significant will in the course of time no doubt develop in Europe, even if conditions are allowed to drift. But what? Time did not save the ancient empires of Babylon and Nineveh. Time did not prevent the overthrow of the Greek and Roman civilizations. Time—six centuries of time—did ultimately bring the world out of the abyss of the Dark Ages. Time, after a period of fearful human decimation, stamped out the black death, virtually unaided by medical science. Time and the Thirty Years' War reduced the German population by one-third; and several generations of time ultimately restored this population. The fearful human costs involved in these tragedies of time are known to every student of history.

Those who are living in the midst of epoch-making changes, such as are now occurring, usually cannot conceive that the civilization which they have come to regard as established, could possibly disintegrate. It is unthink-

able that the great industrial civilization of the nineteenth and twentieth centuries may possibly have reached its height in August, 1914, and may now be in the fateful processes of dissolution. At the conclusion of Chapter V on national budgets the statement was made that "national budgets, persistently unbalanced, will ultimately wreck the entire financial and economic system." The moment has now arrived when we must show why and how.

Forces of Deterioration

We have seen that it is not at all impossible that the present business depression may continue for several years. If such proves to be the case it is clear that it will be found impossible in nearly every country in Europe to prevent a rapid increase in government debts. Business depression results in low profits and incomes, and low profits and incomes mean reduced taxes. At the same time, government expenditures tend to increase wherever unemployment insurance and subsidies are the vogue. "Doles" and subsidies for railroads, public utilities, education, etc., are, in fact, now found in practically every country in Europe. The result of several years of depression would therefore be progressive deterioration of national finances.

Looked at from the point of view of the economic system rather than from the angle of the national treasury, unbalanced budgets mean consumption in excess of current production and a consequent trenching upon accumulated capital resources. Not only is new capital not constructed, but existing houses, railroads, factories, and equipment are permitted to deteriorate. The result is relentless economic retrogression. Although the process may not be apparent to the casual eye, underneath the surface of things the forces of dissolution are irresistibly at work.

The Bolshevists of Russia chose a spectacular method

of wrecking the economic organization of eastern Europe. Seizing the reins of political power, they forcibly dispossessed the existing owners of capital and proceeded to squeeze the industrial organism dry. Unbalanced budgets, with paper money issues to meet government expenses, accomplish the same end in more prosaic ways.

Austrian Debacle

An illustration is to be found in the history of Austria since the war. Austria escaped Bolshevism; but she did not escape almost complete economic and social demoralization. The following graphic account is taken from the Report of the Provisional Economic and Financial Committee of the League of Nations Relative to the Financial Reconstitution of Austria. [1]

"From October, 1919, the value of Austrian kronen fell gradually from 6.02 to .95 Swiss francs. The opposite upward tendency, which within a short period, increased internal prices 50, 60, and 75 times, disturbed the position very considerably; it became more and more unstable in proportion to these increases. All those whose assets were expressed in terms of money were ruined; persons with fixed incomes, pensioners—in short, the middle classes—have been utterly crushed, and are now in extreme poverty. Those who possessed or manufactured any kind of goods secured, nominally at least, considerable profits. Everyone, therefore, has attempted to make provision against this continual fall in the krone. Wage-earners and state employees, in order to counteract the rise in prices, exercised collective pressure and threatened to strike almost daily. But whatever success is obtained in this daily struggle to adapt conditions of life to the increasing fall

[1] Published June, 1921.

in the currency, no one ever ventures to effect savings or economies in kronen. The latter would in a short time be reduced to a fraction of their original value. It is thought better to satisfy the pleasures of the moment. There is, therefore, a considerable inducement to spend.

"What is not spent in unproductive consumption is invested as soon as possible in real securities and estate, goods, jewels, antiquities, industrial securities, etc. But this natural tendency towards thrift is becoming a speculative fever. In the apparent profits which result from the rise in prices, that portion which represents actual labor loses its importance and becomes negligible. The illusion is fostered that profits may be made by simply hoarding goods or representative securities. Capital is thus diverted from productive enterprise to speculative uses. Luxury is growing greater and greater amongst the classes which have profited most by this kind of speculation, whilst the old middle classes, which are the guardians of tradition and social culture, are sinking deeper into misery."

The situation in the Balkan States, in Hungary, and in Poland differs from that in Austria only in degree and time. Time, moreover, bids fair to reduce all to the same approximate level. Indeed, all the nations east of the Rhine—excepting the Scandinavian countries—have been traveling rapidly in the direction that Austria has already taken. Note the following account of recent developments in Poland:

"According to figures quoted by the Finance Minister, Poland is only covering 20 per cent of her expenditures out of revenue. With the steady decline of the currency, wages are rapidly rising. From April, 1920, to January, 1921, wages rose fivefold, while the cost of living advanced not quite four times." [2]

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[2] From the (London) *Economist,* July 2, 1921.

Budgetary Difficulties

When once this process of financial retrogression has got well under way, it becomes practically impossible to check it. It is easy to pass brave resolutions that taxes should be increased and that expenditures should be rigidly curtailed, but it is the hardest task in the world to carry out such a fiscal policy. Unemployment insurance, pensions, and transport, public utility, and other subsidies must be continued if social unrest of a serious nature is to be prevented. The least that can occur when such policy of retrenchment is instituted is the dethronement of the party in power and the election of an opposition party that will restore the doles and subsidies. Moreover, to stop summarily all these expenditures would add to the demoralization of economic and social conditions.

How difficult is the task of balancing budgets may be seen from recent developments in Poland. The present Finance Minister is determined to institute rigid economy in government and check the process of inflation. The strength of his support from the business and financial press may be judged from the fact that when the Polish Cabinet recently voted a supplementary paper issue of 8 billion marks, and the Finance Minister resigned in protest, the Cabinet was bitterly attacked by the press. The result was the repeal of the authorization of additional paper and the recall of the Minister to office. But further inflation either this year or next seems nevertheless certain, for one is amazed to learn that all the Finance Minister hopes to accomplish is to "balance the budget" by means of domestic and foreign loans. It is perhaps unnecessary to state that in the event government loans can be marketed in Poland under present conditions—a remarkably courageous assumption—the government's financial obligations for the ensuing year will thereby only be increased. Additional

government loans may be a lesser evil than the issue of more paper money; but it is nevertheless an evil. Budgets are not to be balanced by going still further into debt.

It is suggested in every country that the veritable host of employees and hangers-on who now clutter government offices and pay-rolls should be summarily reduced. But in many countries the governments dare not follow such a policy, because it would probably result in unemployment and discontent of a revolutionary character. This would certainly be the result if it were accompanied by the cessation of doles, pensions, and subsidies. Government expenditures for such purposes and the padding of official pay-rolls have been the price paid for saving eastern and central Europe—including Germany—from social revolution during the past three years. Industrial unrest is held in abeyance, it is true, but the cost mounts from month to month with never ending regularity.

Business Demoralization

Government deficits, price inflation, and fluctuating exchanges rapidly undermine business enterprise. Not only are the risks of ordinary industry greatly increased; but the sources of both private and government credit are in time dried up. No nation can pay its debts abroad so long as its budget remains unbalanced and domestic consumption is in excess of domestic production. And no private citizen can long maintain his credit standing in foreign countries when his government's finances are approaching irremediable disaster. Private and public credit are indissolubly linked together.

Domestic credit is, moreover, demoralized by the same process. We have already seen how in Austria no one ever ventures to effect savings in kronen and how ordinary constructive industry has given way to a fever of specula-

tion. This has always been an outstanding characteristic of disordered government and private finance. Why stand to lose one's interest or profits from ordinary financial or industrial undertakings as a result of uncontrollable price fluctuations, when fortunes may be made in speculation? It is not uncommon in Austria and other countries of central and eastern Europe for a commodity to pass through the hands of fifteen or twenty speculative middlemen—each taking toll through price advances—before it reaches the final consumer. Such business activity yields monetary profits, but it does not increase production. On the contrary it demoralizes industry.

The rapid mounting of prices and the accompanying disorganization of industry intensify social unrest. Wages must be rapidly advanced under penalty of strikes, and the dominance of the masses over the policies of government is steadily increased. This, of course, progressively complicates the difficulties of the situation and but paves the way for still further disorganization. Sooner or later certain basic industries, such as public utilities and transport, are broken down, and with this calamity disappears practically all hope of saving the whole complex industrial and commercial mechanism, the very existence of which depends upon the efficient functioning of these "key" industries.

One of the factors that contribute most to the demoralization of trade and industry when once a nation has started along the road we have been describing, is the rapid disappearance of that business or commercial morality which constitutes the very foundation of the modern industrial and credit system. It is said that commercial honesty is almost unknown in eastern Europe today. Why should anyone be honest in his dealings, when the almost certain result is elimination from the field of business and starvation in the

not distant future? Dishonesty becomes not only the best but the only policy.

Here lies, moreover, one of the greatest obstacles to the reconstruction of the broken countries of eastern Europe. It is not merely necessary to restore finances, transport systems, etc. The moral foundations of commercial society must also be reconstructed. This is perhaps the most difficult task of any.

The Case of the Netherlands

In the analysis thus far we have been describing the process of social and economic disintegration as it has already been illustrated in eastern Europe. In the other countries of continental Europe the situation now differs only in degree. The price that governments in power must everywhere pay, if they are to continue in office, is the continued increase of the government debt. No government, under present conditions, dares to curtail subsidies, unemployment insurance, etc., and no government dares to increase the burden of taxes sufficiently to cover present expenditures. The government in power knows that politicians out of power would seize the opportunity created by such a policy and return to office on a platform that promised relief for the masses. It cannot be too strongly emphasized that political exigencies make thorough-going fiscal reform at the present time a practical impossibility.

Take the case of the Netherlands. Here was a neutral country—one that made tremendous profits during the war; one whose industrial and financial organization was not disrupted by huge war loans and issues of paper money. The army had to be greatly increased, it is true, and many thousands of refugees had to be cared for. But still the Netherlands was popularly supposed to have emerged from the war in a very strong financial position. Nevertheless,

the Netherlands' budget is now seriously unbalanced, with no present prospect of improvement. Indeed, if the business depression continues, it is foreseen that the deficit will rapidly increase. The Hollanders, like the people of other countries—not excluding those of the United States—naively assumed that the war had laid the basis for a period of unprecedented prosperity, and that the aspirations of mankind for a higher standard of living and a richer existence generally could now find immediate fulfilment.

A program of beneficent social legislation was accordingly undertaken, and unemployment insurance, pensions, educational subsidies, etc., were established. At the same time, the efficiency of labor declined—as in other countries—and the number of working hours was reduced. The result was a government fiscal deficit of serious proportions, even in the good year of 1920. This year, in consequence of the business depression, it will be greatly increased. Meanwhile the government in power is popular with the masses, and it knows only too well that the surest means of losing favor is to abandon the present policy for one of financial conservatism. Thus even Holland has been drawn into the current that leads to progressive financial deterioration. This in spite of the fact that virtual disarmament has been achieved.

British Situation

Take the case of Great Britain. Last year, as we have seen, this nation of financial genius nominally succeeded in balancing the government budget and in actually reducing the outstanding debt, though, as we have seen, it was necessary for the taxpayers to borrow a considerable portion of their tax money.

In consequence of the business depression Great Britain will this year in all probability be faced with an outright

deficit. Now the tax burden cannot well be increased, and the present Coalition government, although it is being subjected to the strongest pressure from the financial and business interests and from the middle classes, is not disposed to make any radical reduction in expenditures. A little may be saved, however, by reducing the number of government employees;[3] but it will be only a drop in the bucket. Interest on the public debt, unemployment doles, and pensions are the major items, and these the government is afraid to reduce at the present time. New military expenses may, however, be reduced in another year. We shall return to this question in the last chapter which is concerned with the real remedies for the present situation.

The political future of England is shrouded in uncertainty. The present government is without any constructive policy and appears to be disliked all-around. But there is no leader in sight with the ability to reform the shattered ranks of British liberalism; and for the present at least, the Labor party appears to be too harried and too divided in counsel to carry an election. Immediately speaking, therefore, a new Coalition government appears to be the most likely political development.

But what would such a government do? If it should attempt to eliminate unemployment doles and pensions, the hand of the Labor party would be greatly strengthened and it would only be a question of time until the latter would win an election. If, on the other hand, such a government should confine its efforts merely to the effecting of minor economies, it could not keep the national budget in balance—assuming a prolonged period of business depression. Even in Great Britain the general situation is therefore one of extreme gravity.

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[3] The number is now, in fact, greater than it was at the time of the Armistice.

Labor Unrest

In one important respect the situation in Europe, as noted in a previous chapter, appears to have improved materially since last year. "Labor unrest is rapidly subsiding." The business depression has proved no less a shock to European than to American labor. The workers in the nations of western Europe are now clearly on the defensive. But what will happen in case the business depression continues for several years? May labor be expected to remain quiescent, offering but a passive resistance to the forces of "detestable economic laws"? There is little ground for such a belief.

Labor has for some time believed—whether rightly or wrongly, we need not now inquire—that there is something fundamentally wrong with the existing system of wealth distribution. It is widely believed that "there is enough for everyone if only it were fairly divided." As a result of the war, labor has also been coming to believe that there is something fundamentally wrong with the system of wealth production. During the post-war industrial boom this conviction was somewhat in abeyance, but it is now cropping out again with renewed vigor, and the longer the business depression lasts, the more deeply rooted this conviction will become. Millions of men unable to procure work will sooner or later seek to find a remedy in political action. Not even unemployment doles can permanently allay the spirit of resentment against those who hold the reins of power and are apparently responsible for the condition of affairs. Witness, for example, our American greenback movement of the late seventies, and the populist and free-silver agitations of the nineties.

A prolonged period of hard times has seldom failed to produce mass political action in one form or another. It may not be bolshevism or communism; it may not even be state socialism, as that term has commonly been understood.

The movement would very likely assume different forms in different countries. But that inexperienced and perhaps injudicious leaders, backed by the masses, will in one way or another take control of government in practically every country in Europe in the event of a protracted business depression, is far from improbable.

Assuming Labor in Power in England

In England, it is more than possible that the Labor party would gain control of the government. In case this should occur it is interesting to speculate upon the probable drift of events. We have the greatest sympathy for the aspirations of British workers and their leaders. It is all too true that England's industrial greatness has been made possible through the payment of bare subsistence wages to labor. And as Mr. Lloyd George—in one of his earlier incarnations—so well said, "The average Englishman is but a trespasser in the land of his birth." Does it follow, however, that the coming to power at the present time of the British Labor party would be for the best interest of the world? It is very doubtful.

Whatever may be the present views of party leaders, there can be little doubt that present money wages would be maintained, and present subsidies and unemployment doles would be continued, if not increased. Labor would doubtless insist on maintaining, if not increasing, present standards of living. An attempt might well be made to impose a capital tax. But at this point capitalists would certainly revolt. There would be a great capital hegira, similar to, but probably much more extensive than, that which already has occurred from Germany. Industry would shortly have to be taken over and operated by labor.

In view of the necessity for Englishmen to meet the industrial competition of other nations, there is little reason to

believe that nationalized British industry—which would be expected to support the working population at "satisfactory" living standards—could compete effectively in world markets. If, however, similar developments were occurring simultaneously in other countries, the situation in this respect would of course be somewhat different, because in all countries labor would then be confronted with the practically impossible task of producing as much as "reasonable living standards" require. Budgets would in all probability be more seriously unbalanced than ever, and the printing press would appear to be the only way out. The process of price inflation might for a time create the impression that the "new day" had at last been ushered in, when in fact economic retrogression would be proceeding at an accelerated pace.

It is unnecessary here to conjecture what effect such a political outcome would have upon the unity of the British Empire. One thing is certain, however, that stability in world affairs would not be increased; and more than anything else the world needs stability, both economic and political. More than anything else, the co-operation of relatively strong governments, such as those of Great Britain and the United States, is required in promoting peace and in re-establishing trade and industry. Indeed, without the co-operation of these two great divisions of the Anglo-Saxon race, there is little hope for political and social stability in the world of the twentieth century.

Distribution of British National Income

We have said in a previous paragraph that a Labor party in power would attempt to maintain living standards unwarranted by the volume of production. If so, the accumulated supply of capital would be steadily depleted, the volume of production would gradually decrease, and the standard of living would gradually be forced to lower and lower levels.

This is exactly what has been occurring since the Armistice, even under the Coalition government; and the world is already beginning to pay the penalty. The following figures of the distribution of the national income in Great Britain in 1920 as compared with 1907 are little short of appalling. They are compiled by Edgar Crammond, the English statistician to whom reference has been made in a preceding chapter.[4]

	Percentage of Total Income	
	1907	1920
Food, drink, and tobacco	22.4	28.4
Dress	11.5	12.5
House	11.4	8.0
National services	8.5	23.0
Miscellaneous	8.6	8.0
Professional and domestic services, not comprised in above items	4.6	4.5
Cost of distribution	9.3	10.2
Depreciation and maintenance of capital	8.3	
New investments at home	7.4	5.4
New investments abroad	8.0	
	100.0	100.0

Three striking facts are revealed by these data: (1) In 1920 the British people spent 7 per cent more of the national income on food, drink, tobacco, and dress than they did in 1907. They lived substantially better. (2) Government expenditures (national services) were almost trebled. (3) The percentage devoted to the maintenance of existing railroads, warehouses, factories, equipment, etc., and to the creation of new capital equipment at home and abroad (the last three items in the table) has been reduced from a total of 23.7 to 5.4.

The grim truth is that in the boom year of 1920 England

[4] Printed in the *London Times,* June 28, 1921.

did not even maintain the supply of existing capital—the industrial machine was being allowed to run down. Note the 8.3 per cent spent in 1907 for depreciation and maintenance alone, as compared with the 5.4 per cent in 1920 for all capital purposes. These figures conclusively demonstrate that in the "prosperous" year of 1920 Great Britain was actually going backward. She was living much beyond her means.

Mr. Crammond estimates that for 1921 the national income, in terms of money values, will be so greatly reduced that about 32 per cent will be required to meet government expenses. There is, moreover, not the slightest doubt that the percentage spent for capital replacement and new construction will be even less than a year ago. Comparable data on the distribution of national income in other European countries are not available. But the evidence afforded by trade statistics, national budgets, etc.—all indicates that in practically every continental country the situation in this respect is substantially worse than in Great Britain, or if not immediately worse, has been temporarily alleviated only by huge additions to the national debts. Everywhere those living on pensions, interest on government bonds, and unemployment insurance are being supported out of capital.

Decline of European Capital Supply

Let it be understood that we are holding no particular group responsible for this condition of affairs. We are merely calling attention to the startling facts in the situation. No single group, indeed, is to be blamed. This whole situation was doubtless an inevitable aftermath of the war. Few people—in any walk of life—would admit for a moment that post-war standards of living would have to be reduced. Indeed, the chorus proclaiming an era of improved living conditions for everyone was all but unanimous. It is one of the most amazing illustrations of the practical universality

of economic ignorance that most people should have confidently believed that four years of concentrated wealth destruction had placed the world in a position to expand its scale of consumption. The bitter truth has not even yet come home to more than the merest fraction of the world's population, that the war means lowered standards of living for the world as a whole for at least a generation. Until this truth does penetrate to the masses of mankind, there is little hope of checking the progressive reduction of wealth-producing power that is now occurring.

The financial and industrial system of our day, if it is to endure, must annually effect such a distribution of the national income and of the national productive power that existing capital goods—railways, factories, equipment, etc. —are maintained in good repair. A failure to do so means, inevitably, persistent economic retrogression. If wealth production is to be increased as the years go by, and if the low existing standards of living are to be raised, additions must be made each year to the present depleted capital equipment of society. These are elemental economic principles, which no one can successfully controvert.

Now the truth is that the world as a whole—even in the halcyon days of the generation immediately preceding the war—did not possess much of a growing margin, did not annually add very much to the existing supply of capital goods. Estimates vary somewhat, but for the world as a whole the annual capital increment was probably somewhere between 5 and 10 per cent. In that great investing nation, Great Britain, in the excellent year 1907 it was only a little more than 15 per cent, according to Crammond's estimates given above. The incalculable economic costs of the war may in no way be better understood than by comprehending that in all Europe this margin of saving—this means of economic growth and progress—has been wiped out.

Supreme Problem of Generation

If the economic organization of the twentieth century is to survive, somehow this margin that constitutes progress must be restored; at the very minimum existing capital goods must annually be replaced. Where does one find assurance that this will occur? If the reply is that what the world needs is thrift—relentless, never-ceasing thrift—it will be well to reflect that if by thrift is meant rigid curtailment of consumption, the business depression will not thereby be quickly overcome. If prosperity is to be restored there must be a revival of demand—of consumptive demand. Additional factories, etc., will not be constructed unless there is an effective demand for the products which such factories would have for sale; nor will additional factories be constructed so long as the output of present factories cannot find a profitable market. The way to overcome depression is not by intensifying the present lack of demand for consumption goods.

On the other hand, lavish spending and extravagant consumption are equally disastrous, as events since the Armistice have clearly demonstrated. To make a long and far from simple story short, if the economic world is again to be set moving in the direction of material progress, we must somehow secure a return of prosperity, develop a high degree of industrial efficiency, expand output, and devote meanwhile a sufficient percentage of our social energy to the creation of capital to ensure the replacement of the productive wealth that is annually worn out, and to add a little—if ever so little—to the existing stock of capital goods. This is the supreme problem of the present generation.

If the business depression should in the near future be broken—either as the result of some fortuitous development or in consequence of co-operative international economic policy—the task of restoring the margin that spells progress

will of course be rendered much easier. But let none assume that it would then automatically take care of itself. It will be well to recall that Great Britain, for example, had prosperity in the year 1920; yet, as we have seen, the existing supply of capital goods was not even maintained. A part of the problem is obviously that of somehow lessening the burden of taxation to the end that funds may be available for investment.

Change of Economic Systems

Moreover, even if the depression is shortly broken, it will still be true that society must for years be content with a lower standard of living than it had obtained in the latter years before the war. The economic machine has been so thoroughly disrupted and the producing power of the world so seriously reduced, that it will require many years to restore our former standards of living. It cannot be too strongly emphasized that the real economic costs of the war are yet to be borne by the world—borne through reduced income for nearly everyone; borne unfortunately (for society is thus organized) through downright privation for the great masses of people.

If the present economic system, whose many defects must be admitted, has broken down under the unprecedented shock of the war, why, it may be asked, attempt to restore it? Why not substitute a new system in which the defects of the old are eliminated? Aside from the failure of anyone to suggest a workable economic system to take the place of the present one, there is a fundamental objection to attempting any extreme social and industrial experiments at such a time as this. The present complex international industrial system is the result of a gradual growth of centuries. Not only is the complex machinery of wealth production and distribution in each country welded into this economic system;

but the entire political and social organization is inextricably bound up with it.

Granted that the existing economic system has serious—nay, fundamental—deficiencies, what assurance can anyone give that an attempt in these disordered times to substitute some other conceivable system for it, would not result in utter disaster? The present depreciated and unstable exchanges of the world, to take a single example, work havoc with commerce and with production. But what would one suggest as a practicable and workable alternative? International barter has been tried since the war; and it has failed. No other suggestion of a substitute for the exchange mechanism has been advanced during the three years of need.

The extensive reforms of the existing economic order—which every intelligent student concedes to be necessary—must wait until a more propitious time. Experience teaches that violent changes and extreme experiments, particularly in a time of economic stress, are the surest means of destroying wealth production and of intensifying the disorders they are intended to overcome. The great requirement in the present world emergency is to restore, as well as may be, the normal functioning of the existing economic system.

Problem an International One

In concluding this analysis of the economic and social consequences of the war, the authors feel impelled to caution the reader against a not improbable misinterpretation. Since pre-Armistice days, various writers have suggested the possibility of an economic collapse in Europe following the war. They have spoken of the war as marking the end of an economic and social era. In nearly every case the meaning of this suggestion has been misunderstood. To the average person any suggestion of European economic and social disintegration carries with it the thought that all of Europe is

overnight to sink beneath the waters of the sea, or to be consumed in some sort of gigantic social conflagration. Great bankers in sober addresses before staid business men have been known to insist with vehemence that Europe cannot possibly "go under." Europe, it is urged, has never gone down, however great the strain to which she has been subjected; and when all the present prophets of disaster are dead and gone, civilized men will still be living on the continent of Europe and in the islands west of the channel.

The point is not that Europe is to be plunged overnight into some unfathomable abyss, never to rise again. The point is not that every living being from the Bay of Biscay to the Ural Mountains, from the Arctic Ocean to the Mediterranean Sea, is to be destroyed. The point is only that in present conditions one may discern real possibilities of a long period of gradual decline in economic and social well-being—a slipping back to the conditions of a century or more ago.

Even Russia will survive. Many millions of people will continue to live in those vast agricultural steppes of eastern Europe, whatever may be the fate of Russian industrial life. But some millions of Russian city folk have already perished and Russian agriculture is rapidly reverting to the stage of hoe culture. It is not at all beyond the bounds of possibility that all of continental Europe might in the course of the next twenty-five years, or even sooner, go the way that Russia has already gone. It would not necessarily be through the instrumentality of bolshevism; it might as easily be in the Austrian way. But in any case it would mean a great decrease in urban population, through starvation and migration, mainly the former; and it would involve great reductions in living standards even for the agricultural communities.

This dire consummation may occur. Indeed, it is not at

all unlikely that it will occur, unless the statesmen of the world—both political and industrial—unite in some comprehensive program of international economic reconstruction. We have faith to believe that it need not happen if the senseless optimism and narrow provincialism that has stood ever since the Armistice as a bar to the formulation of a constructive policy, be supplanted by an intelligent appreciation of the real gravity of the situation, and a statesmanlike recognition in each country of the necessity of viewing the problem as essentially an international one.

CHAPTER XI

THE UNITY OF THE PROBLEM

Europe an Economic Unit

In the foregoing analysis of the fundamental elements in the European economic situation, little detailed attention was given to conditions in each of the several countries. With the exception of the chapter dealing with the German monetary collapse, the analysis was, in the main, centered upon the various gauges or indexes of European conditions in general; and data were drawn from particular countries only for the purpose of illustrating the principles or conditions under consideration. No attempt was made to discuss the Italian or the French or the Belgian or the British situation, in great detail and in all its aspects, with a view to demonstrating that this, that, or the other particular country —by itself—is at this particular time either improving or retrogressing.

While there are undoubtedly marked differences in the general economic status of the various countries at any given time; indeed, while the nations of Europe, as we have seen, may be classified into three or four groups representing varying degrees of economic decadence—with Russia and Austria at one extreme and England and the neutrals at the other—there is little to be gained by making a detailed analysis of monetary conditions in each individual country. It is only the European economic organization as a whole that is important. Europe is an economic unit, and all nations will in the end improve or relapse together. Because of peculiar conditions, some countries will suffer more than

others in the event of a long period of economic and social retrogression; but by and large, all are in the same boat.

If Poland, Finland, Hungary, Czechoslovakia, and the Balkans continue to travel, as they are now traveling, the route that Austria, as well as Russia, has already taken, it is difficult to see how German trade and industry, which are so largely dependent upon eastern European markets, can escape serious depression. And if Germany, because of this, in conjunction with the stupendous difficulties to which she has—in her own right—fallen heir, goes the way of the other countries of central and eastern Europe, the consequences upon both neutral and Allied economic—and political—life will be extremely grave.

Economic Pivot of Europe

Modern Germany—the industrial Germany that was founded with the empire in the decade of the seventies—is the economic pivot of continental Europe. The evolution of the vast financial and economic organization of Germany during the last quarter of the nineteenth century and the early years of the twentieth—however disastrous the accompanying political developments—was primarily responsible for the remarkable economic progress during this period in all continental Europe.

In the first place, the development of German industrialism alone made possible the phenomenal growth of population, within the confines of the empire, from 40 millions in 1870 to 68 millions in 1914—a growth of population, moreover, that was accompanied by a steadily rising standard of living. What this increase of population and of purchasing power meant to neutral and Allied nations cannot well be overemphasized. Before 1870, Germany was a poor agricultural nation, largely self-contained. Then, within a single generation Germany became a land of affluence, and a major

purchaser of Italian, French, Belgian, Dutch, Scandinavian, British, and American exports. German industrial life was so organized that a large percentage of the raw materials required for her industries were imported; and she was also a large importer of finished commodities, particularly of luxuries produced by Italy, France, and Belgium.

While Germany, as a matter of course, exported finished commodities to the nations of eastern and southeastern Europe and also to the industrial nations of the west, German prosperity was, nevertheless, of the greatest benefit to other industrial nations. German exports, which protectionists so violently denounced, afforded Germany the means with which to buy the commodities she imported from other nations. Both Germany and other industrial nations throve because of specialized production and exchange. The international trade—with emphasis on the *trade*—that developed between other nations and the puissant Germany of the generation before the war was mutually beneficial.

Financial Germany

In the second place, the development of financial Germany was the principal factor in increasing population and productive efficiency throughout all of Europe east of the Rhine. Germany, with Austria, financed the major part of the economic development that occurred in eastern and southeastern Europe in the latter years before the war. The economic life of this vast territory radiated from the financial offices of Berlin, Hamburg, Frankfort, and Vienna. One of the most interesting chapters in the whole history of economic evolution is found in the remarkable union between German finance and German industry, both at home and in surrounding countries, that was developed in the heyday of the empire. We are not here concerned, let it be repeated, with the political consequences of this de-

velopment. We are for the present interested only in its relation to the economic prosperity of Europe during the period when it flourished.

It was not alone through finance, moreover, that Germany organized, controlled, and developed the economic system of central and eastern Europe. German shipping and German commercial organization were almost as important. As the geographical heart of the continent, Germany was peculiarly favored in her development of the shipping lines and commercial connections with which before the war she directed the commerce of nearly the whole of central and eastern Europe to the borders of Asia.

To those who, still under the influence of war psychology, look for the re-establishment of European security and prosperity through the destruction of Germany, the answer is that such a process would inevitably spread its devastating effects throughout all Europe. It cannot be too strongly emphasized that the purchasing power of Germany, and through Germany the purchasing power of all central and eastern Europe, is essential not only to the prosperity of western Europe; one may almost say it is essential to the perpetuity of the industrial life of highly developed nations such as England.

Interdependence of Economic World

We have thus far spoken only of the effects of the economic disintegration of eastern and central Europe upon the nations of western Europe. It remains to consider the probable reaction of a catastrophe, such as has been foreshadowed, upon American economic life. While intelligent people everywhere now assent to the doctrine that the modern economic world is essentially interdependent, with the many such assent is only lip service; relatively few

fully appreciate how intricately interwoven is the economic life of modern nations.

Some vague notion of the close nexus of international financial relations may be gained from considerations such as the following: When the great speculative mania in the Argentine in the decade of the eighties, accompanied by the issue of vast quantities of irredeemable paper currency, collapsed in 1890, it resulted in the failure of Baring Brothers, one of the greatest international banking houses of England, all but precipitated a general financial panic in Europe, and led to a very serious unsettling of American financial conditions. Similarly, financial difficulties in Japan and Egypt in 1906 contributed to the forces that were bringing on the American panic of 1907, while the repercussions of this panic in the United States were felt in every market of the world. For example, it was felt severely in the caravan trade from central Africa across the Sahara desert to Tripoli. Every period of prosperity of modern times has sooner or later spread throughout the entire world; and every important period of liquidation, wherever beginning, has in the end made itself felt in every nation. The present "world-wide" depression, for example, began in Japan; it spread to the United States, to South America, to Central America, to Europe, to Australia, to Egypt, to India, to Cape Colony, to Siam. There is not a spot on the globe that is within the field of commercial civilization that has not felt severely the effects of the post-war liquidation.

American Dependence on Foreign Trade

These are, however, only general statements. Specific data are required to reveal to the uninitiated how closely interrelated is the economic life of modern nations. The following statement taken from one of the publications of the Guaranty Trust Company of New York, based upon

practical trade information coming into the bank, indicates in some detail the nature of the dependence of trade between the United States and foreign lands since the war.

"Danville, Va., is interested in sending tobacco to Venezuela; La Porte, Ind., wants to send farm tractors to Brazil; St. Joseph, Mich., desires an agent for automobile accessories in India; Durgettstown, Pa., sends an inquiry regarding industrial enterprises in Jugoslavia; Parkersburg, W. Va., wants to sell oil well supplies to Mexico; Keokuk, Iowa, is interested in developing a market for rolled oats in South America; Coshocton, Ohio, wants to appoint an agent in Spain for its glass bottles; Cadillac, Mich., desires to ship veneer to New Zealand; Monessen, Pa., is interested in steel wire in South Africa; Charlotte, N. C., wants to send cotton to Finland; Norfolk Downs, Mass., has a customer for weighing machinery in Formosa; Mount Pleasant, Mich., has a customer for trucks in Guatemala; and Valdosta, Ga., wants to export cotton linters to Czechoslovakia.

"A recent analysis of the cargo carried by a United Fruit liner sailing from New Orleans to South American ports showed that practically every community in the United States, manufacturing or agricultural, had some part in the production of the cargo sent out in this steamer."

Nor is the United States interested merely in exports. The statement goes on to say:

"In order to provide a sustained market for our surplus manufactures, we must have a regular and increasing supply of many commodities which are not produced in the United States, or which are produced in such small volume as to be entirely inadequate for our requirements. We must obtain manganese for our steel mills from Russia and South America. Our tanneries must have quebracho from Argentina; our automobile tire industry must obtain crude rub-

ber from Brazil; our machine shops, rail mills, armored plate works, and wire rope factories must have nickel from Canada and New Caledonia; our tinplate manufacturers must import their tin from the Malay Straits and from Bolivia; our silk factories must get their raw product from China and Japan; our clothing wools must be imported from Australia and Argentina; our manufacturers of twines, canvas, linens, and laces must get their flax from Russia and Belgium; our burlap makers must get their jute from India; the sisal which is used to make our binder twine, which is so essential in the harvesting of our crops, must come from Yucatan. We must also import large quantities of cocoanut oil and other vegetable oils from the Dutch East Indies and from the Pacific isles; coffee from Brazil, tea from China, India, Japan, and Java; cocoa from Venezuela; sugar from Cuba; rice from the Far East; spices from the East Indies; platinum from Colombia; and vanadium from Peru."

The following statement by the president of one of our greatest banks, suggests in concrete fashion the effects of the decline in European purchasing during the past year upon American economic conditions.

"The reactions here of economic disturbances in Europe are beginning to manifest themselves so plainly that every element of our body politic—the business man, the banker, the manufacturer, the farmer and the laborer—cannot fail to see and feel them. The most patent and perturbing evidence of those reactions is the present unemployment in the United States, unquestionably due in considerable degree to world-wide conditions.

"Almost half of the country's record corn crop of last year remained on the farms on March 1, more than a quarter of the wheat crop, and almost half of the large crop of oats. There is about a two years' supply of tobacco and wool on

hand. The bituminous coal industry is developed far beyond present or immediate future demands of domestic trade. The automobile trade is oversupplied with cars. There are indications of an oversupply of zinc, shoes, and manufactures of leather.

"The surplus copper, raw and refined, in this country, is estimated at more than 1,000,000,000 pounds. Europe formerly took about half of our copper, and the world depends upon the mines, refineries, and smelters of the United States for its copper. Yet, despite our enormous surplus, the whole world has not been so badly in need of copper in years as it is today. Lack of credit alone has been responsible for the piling up of that surplus of the red metal.

"In one middle west state manufacturers face a loss of $20,000,000 in current export orders from southeastern Europe alone. Flour millers have inquiries for large shipments to Poland and Czechoslovakia, where the prospective purchasers are eager to put up sugar certificates and government bonds for six months' credit. Prospective Roumanian purchasers offer government bonds, oil certificates, and cash. Scandinavian seekers of American electrical machinery have offered tax warrants as collateral for long-term credit arrangements. Egyptian importers are in the market for almost every manufactured article produced in the United States—particularly American specialities, such as typewriters, sewing machines, automobiles, etc. Shipments of coal to South America amounting to hundreds of thousands of dollars are being held up because the South American buyers cannot arrange dollar credits in New York."

American Agriculture and Foreign Markets

Notwithstanding such facts as these and in spite of all the emphasis that has been placed by bankers and others

upon the necessity of maintaining our export trade if the country is to prosper, one hears men say on every hand that whatever happens in Europe this great country of ours will not be seriously affected. Let our foreign markets go, if need be. It is urged that they are relatively unimportant anyhow; for our foreign trade is only 10 per cent—or is it 5 per cent—of our total trade. Rather than grieve over the loss of foreign markets, let us confidently devote our attention to developing our home markets. Is not the consuming capacity of the American people limitless in extent? Think of the enormous numbers of people who still have no automobiles; think of the number whose homes are not elegantly furnished; think of the number, if one must, who are still scarcely above the minimum of subsistence. Why worry about foreign markets when such vast potential demands are to be found within our own borders?

Brave words these; but based upon fundamental misconceptions of the working of economic forces. Large and thriving domestic markets, unfortunately, depend upon foreign markets; they cannot readily be stimulated when foreign markets are waning. Moreover, it is altogether misleading to argue that since our export trade as a whole constitutes only 5 or 10 per cent of our total trade, it is relatively unimportant. The truth of the matter is that practically 50 per cent of our total cotton supply is normally exported, and from 25 to 30 per cent of our wheat crop. In many lines of industry our exports are altogether negligible; while in certain other important industries the export trade is of paramount significance. While one might argue with a show of plausibility that a 5 per cent loss of trade is not significant, he cannot argue with equal cogency when the percentage that is involved is 20 or 30 or even 50, as in the case of cotton.

There is no escape from the conclusion that if American

exports of cotton and wheat should be very greatly reduced as a result of European decadence, the cotton belt and the wheat belt would be seriously depressed for years to come. In this connection, it would be well to remember that the present depressed condition in the South and in the grain-growing regions of the West exists in spite of the relatively good European demand for cotton and wheat.

Effect on Domestic Trade

It is idle to hope that our manufacturing industries—if shorn of their foreign markets—could, under the conditions prevailing, immediately devote their attention to the manufacture of goods for sale to the people of the cotton districts and to the wheat farmers of the West. Cotton and grain growers can purchase the products of domestic manufacture only when a strong foreign demand affords them a paying price for their products. And under a profit-making system manufacturers will produce goods for sale to farmers, or anyone else, only when it pays to do so.

During the war period, in consequence of the inordinate foreign demands for American raw materials and foodstuffs, producers of cotton and food enjoyed unprecedented prosperity; whereupon they proceeded to purchase, with an abandon never before equaled, the produce of American manufacture. The expanded domestic demand was definitely a result of the large foreign demand. The tide has now been reversed; and we shall not be able to expand materially our domestic sales in the agricultural regions of the South and West so long as the foreign demand for their produce continues to decline.

The point of this analysis is that since a decline in foreign demand may cause economic prostration in certain basic industries in the United States and since the effects of this are felt throughout the entire industrial system of the

country, the loss of our foreign trade is of vital importance. A decline of foreign trade carries with it, for at least a considerable period of time, a decline in domestic trade.

The qualification, "for at least a considerable period of time," will be noted. The North American continent is economically self-sufficient; and it is large enough and diversified enough to permit an extensive geographical specialization in production. In the long run we might, therefore, effect a vast reorganization of the channels of trade and of financial relations, and get on well enough without Europe. The trouble is that we are just now faced with the short run, which must be completed before we shall have an opportunity to engage in the longer jaunt. Our economic organization is adjusted, as a result of the trade and industrial evolution of the last hundred years, to trade with Europe. The process of reorganizing the industrial system on wholly independent lines would involve the gravest industrial consequences and require many years to accomplish.

Again we must come back to the question of imports. If the power of European nations to produce commodities required by the United States is seriously impaired, this will carry with it not merely a reduction in European ability to buy goods from us, but it will in many cases seriously hamper American industries as well. Run back over the list of commodities mentioned in the quotation above that must be imported by the United States, and you will find that the maintenance of imports is quite as essential to American prosperity as the maintenance of exports. The maintenance of trade, whereby the modern system of specialized production is made possible, is the vitally important requirement.

General Debacle and Industrial Nations

All nations, then—even the United States—will have to bear the industrial consequences if the process of economic

and social disintegration in central and eastern Europe is allowed to run its fatal course. It remains to inquire what nations might be expected to suffer most heavily from the effects of such a catastrophe. As was indicated in the previous chapter, a complete financial and economic collapse in Europe does not imply the utter annihilation of peoples and nations there. All nations, even Russia, will somehow survive, although with greatly decimated and impoverished populations. It is a reasonably safe prediction, however, that the nations that are primarily agricultural would suffer least and recover most quickly. The great industrial nations with their teeming urban populations, such as Germany and Great Britain, would suffer most. The United States is in a separate category, partly because of our geographical position and partly because of the importance of American agriculture. Interestingly enough, Great Britain, although still in much the strongest position of any European belligerent, would doubtless suffer more than any other country in the event of a general debacle, because there the delicately adjusted complex industrial organization of the present age finds its most complete exemplification, and because there agriculture is of negligible importance.

The highly developed industrial nations would suffer most, for the reason that in such countries the largest percentage of the population is dependent for the means of existence upon the smooth functioning of the delicate machinery of international trade and finance. For example, let British exports of coal and of manufactured commodities to the continent of Europe practically cease for a single year and the major portion of British industry would be prostrated, with something like half the population of the islands without means of subsistence. Such a crisis would, of course, quickly threaten social and political revolution; for men without bread, as recent riots in England indicate, will

not long refrain from resorting to extreme measures for relief.

Better Position of Agricultural Countries

Dominantly agricultural nations would suffer less than industrial countries, for the reason that they are not quite so vitally dependent upon the successful working of the international economic organization. A much bigger percentage of the population would still have access to the sources of food supply. For the same reason, political and social upheaval would there be less likely than in the urban deserts of industrial nations.

The conclusion is quite unwarranted, however, that agricultural nations would suffer but little. We have already referred to the probable effects of a collapse of the European demand for American cotton and wheat upon the economic well-being of the agricultural populations concerned. We may now refer to the consequences of the disintegration of Russian industry—unimportant as it was—upon Russian agricultural life. Russia has already become, to all intents and purposes, an assemblage of isolated agricultural communities, reduced to the stage of hoe culture, eking out a pitiable existence by the process of direct appropriation of natural resources. If it be replied that agricultural Russia was never far advanced in the scale of civilization, the answer is that even so there has been a disastrous decadence. A Russian famine such as that of the present year would not have been possible before the war.

The truth is that agriculture is dependent upon industry, even as industry is dependent upon agriculture. The growth of agricultural population, the intensive development of old agricultural areas, and the extensive development of new ones that has occurred during the last century, have been

made possible only by the growth of great urban populations and the huge industrial output that accompanied the evolution of the modern industrial system. If the complex industrial organization of the present day is destroyed, or merely set back for a generation or so, in consequence of the working of the economic forces which we have been considering, it will be impossible for the agricultural prosperity that accompanied the rise of the industrial system to hold its present position. If the modern financial and industrial organization disintegrates, agriculture everywhere will inevitably revert at least to the conditions that obtained at the middle of the last century.

We have sought to establish in this chapter that the modern world is an economic unit, and that no part of it can prosper when other important portions are in decadence. That central as well as eastern Europe is foredoomed to collapse, was not, however, conclusively demonstrated in preceding chapters. The presumption merely was established, and this only in the event that effective remedial measures are not adopted. We must, however, still postpone the consideration of remedies. For the possibility of a European recovery is closely associated with the task of maintaining international peace; and the task of maintaining international peace is unfortunately still intimately connected with the problem of German reparations. Notwithstanding the reparations "settlement" that was finally effected in May, 1921, we shall find that reparations is as unsettled a question as ever. Part II of this volume will be devoted to a discussion of the reparations dilemma.

Part II—The Reparations Dilemma

CHAPTER XII

HISTORY OF THE REPARATIONS CONTROVERSY

The Central Political Issue

The reparations issue, from the very elements which compose it, must continue to be the storm center of European politics. The payments to be made by Germany cover a long period of years. If Germany is to pay, she must develop (as will be shown in succeeding chapters) an excess of exports over imports on a scale never attained hitherto by any nation, save under the stimulus of huge war demands. The burden of expanding exports in unprecedented fashion is, moreover, laid upon Germany at a singularly unfavorable time; for the freedom of commercial intercourse and equality of trade opportunity urged by President Wilson in his fourteen points has given way to a protectionist sentiment and a policy of trade restriction that finds no parallel since the "mercantilist" era of the seventeenth and eighteenth centuries.

There is foreshadowed, therefore, in the world situation, the probability that Germany will constantly be, to a lesser or greater degree, in default on her reparations payments. The reparations question will continue to be the outstanding political issue in each nation which has money to receive or to pay on reparation account. This conclusion is inescapable, in view of the debt and budget situation in each of the Allied

countries and in Germany, as outlined in previous chapters. The mounting burden of debts and taxation in such countries as France and Belgium will seem to make the continued payment of German reparations vital to their solvency. At the same time the mounting burden of debt in Germany and the threatening collapse of the whole financial system will make reparations the central political issue there.

A brief history of the reparations controversy to date will reveal the underlying forces which will control the political history of Europe for the next generation. For these reasons we have considered that a detailed analysis of what may best be described as the reparations dilemma is necessary to an understanding of the economic and political future of Europe. Since the problem is an intricate one we have divided the discussion into a number of chapters.

Procedure of Discussion

The reparations issue has passed through various stages since it first arose in connection with the discussion of the Armistice. A preliminary chapter on the history of the reparations controversy is, therefore, required as a background for a study of the fundamental issues involved. The present chapter serves that purpose. Here we do not enter into controversial discussions, but confine ourselves to a plain statement of the facts up to the "final settlement" of May, 1921.

The next chapter is devoted to a consideration of the much discussed question of German ability, or capacity, to pay the sums demanded by the Allies.

Chapter XIV takes up the question of Allied willingness to receive from Germany the goods and commodities with which alone Germany can pay. It will be shown that while, on the one hand, the Allied nations are demanding huge reparations payments from Germany under the threat

of further military occupation; on the other hand, under the pressure of their own industrialists, they are developing economic policies which render it practically impossible for Germany to pay.

Chapter XV is devoted to a discussion of the economic effects of reparation payments upon the nations receiving them and upon the nations paying them.

Chapter XVI explains the new phase of the reparations question that has developed during the summer of 1921. We refer to the so-called rapprochement between France and Germany, whereby it appears that a considerable portion of the French share of the reparation payments are now to be received in the form of materials for reconstruction.

Chapters XVII and XVIII will attempt to outline the political angles of the reparations question, and to depict, so far as the chaotic situation will permit, the major factors which now make up the European political situation.

Preliminary Terms

The first attempt to formulate officially the terms of the reparations payments which Germany was to make under the Treaty of Peace, came before the Armistice. A series of diplomatic notes were exchanged between Germany and the United States and Allied governments. It was in October, 1918, that the German government asked President Wilson whether the Allied and Associate Powers were willing to make peace on the basis of the President's fourteen points and his other public utterances, in which were set forth the war aims of the President. There was one declaration in these war aims which concerned payments to be made by Germany. This declaration stated that "invaded territories must be restored as well as evacuated and freed." [1]

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[1] President's note to German government, November 5, 1918.

President Wilson communicated the German note to the Allied governments and asked whether they were willing to make peace on this basis. The Allied governments, after consultation, answered in a joint note that they would agree to make peace on the basis indicated, with certain exceptions noted. One of these exceptions was on the point in the Wilson declaration that "invaded territories must be restored as well as evacuated and made free." The Allied governments intimated that this statement was not definite enough, and, to make clear their meaning, they used the following expression: "By it they (the Allied governments) understand that compensation will be made by Germany for all damage done to the civilian population of the Allies and their property by the aggression of Germany by land, by sea, and from the air." [2] The agreement between the executives of enemy and Allied countries was completed when President Wilson communicated the fact to the German government that the Allied and Associate Powers would make peace on the terms specified, including the exceptions designated.

The Armistice Provision

The Armistice followed, the terms of which were dictated by the United Command. The terms of the Armistice concerned themselves principally with the military measures necessary to make Germany incapable of renewing hostilities in case the subsequent peace negotiations failed. There was, however, inserted in the Armistice agreement a clause, the authority of which is accredited by Tardieu to M. Klotz, French Minister of Finance, which concerned reparations. This ambiguous clause required that Germany must pay reparations for damage done, with the reservation that "any

[2] Quoted by President Wilson in Note to German government, November 5, 1918.

subsequent claims of the Allies and the United States remain unaffected." It will be seen that "subsequent claims" might mean either claims subsequently to be advanced or claims for subsequent damages. This clause contains details of reparations to be made during the Armistice; and Keynes points out that the reservation concerning subsequent claims was inserted to affirm that the list of Armistice reparations did not cover all reparation claims of the Allies.

Discussion in Peace Conference

In the Peace Conference that followed, a difference of opinion arose as to the meaning of this phrase in the Armistice and its binding power on the Peace Conference. M. Klotz, then President of the French Commission on Reparations, claimed that the Armistice terms, and not the previous diplomatic correspondence, controlled the decisions of the Peace Conference. He argued that under the Armistice clause, Germany might be charged with the whole cost of the war. Mr. Dulles, the American delegate on the Reparations Commission of the Peace Conference, answered that the diplomatic correspondence of October, 1918, leading to the Peace Conference, referred not to the Armistice but to the peace terms and that the Armistice agreement could not change the agreed basis of peace.

Undoubtedly the French and British delegates were influenced by their own political situation. Lloyd George had conducted a campaign for re-election, on the issue that Germany should be made to pay the whole cost of the war. M. Klotz had delivered a speech in the Chamber of Deputies, demanding German war costs to the last franc. The American delegates contended, however, that the pre-Armistice agreement provided that Germany should pay no indemnity, indemnity being defined as compensation for military expenditures, and therefore to be distinguished from repara-

tion for damages inflicted upon the Allies by German war activities.

The discussion in the Reparations Commission of the Peace Conference brought out the fact that the total war cost was so stupendous that Germany could not possibly pay it all. M. Tardieu estimates the total direct cost at one trillion gold francs, or about three times the total estimated wealth of Germany before the war.[3] There was, moreover, another practical reason why those Allied nations which were most insistent upon full indemnification were willing to abandon the claim for total war costs. If total war costs were assessed against Germany, those countries which had been devastated would receive a smaller percentage of the indemnity paid by Germany. For example, France would be entitled to 65 per cent of the actual damage done to civilians and their property, whereas she was entitled to only 20 per cent of the total war costs.

The declared purpose of the Peace Conference was to make Germany pay up to the limit of her capacity. And since it was recognized that this would constitute a sum far less than the total cost of the war to the Allies, France naturally preferred to receive 65 per cent of what Germany could pay rather than a claim for 20 per cent of what Germany ought to pay.[4]

To satisfy the public declarations of the Premiers of France and Great Britain, a provision was inserted in the Treaty, stating that Germany, although liable for the total cost of the war, was unable to pay in full, and should therefore merely make compensation for all damage done to the civilian population of each Allied and Associated Power

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[3] See quotation on page 177.

[4] Although the United States had more to gain from the assessment of total war costs against Germany than any other nation, the representatives of the United States stood out against the proposal.

and to their property by German aggression by land, by sea, and from the air.[5]

Treaty Terms

A further disagreement arose in the Reparations Commission of the Peace Conference as to what might be included under these terms. The following categories were finally inserted in the Treaty:[6]

1. Damage to injured persons or surviving dependents by act of war, either by German or allied forces.
2. Damage caused by Germany or her allies to civilian victims of all acts of cruelty, violence, or maltreatment.
3. Damage caused by Germany or her allies to civilian victims of all acts of injuries to health, capacity to work, or to honor.
4. Damage caused by any kind of maltreatment of prisoners of war.
5. Pensions to naval and military victims of war.
6. Cost of government assistance to prisoners of war.
7. Allowances to families of mobilized persons.
8. Damage for labor without remuneration.
9. Damage to property injured or destroyed by Germany or her allies.
10. All levies or fines imposed by Germany or her allies.

Mr. Dulles, American representative on the Reparations Commission, opposed the inclusion of pensions. He contended that pensions to soldiers were not payments for "damages to the civilian population," under the legal interpretation of the words. President Wilson, however, overruled Mr. Dulles and inserted pensions in the reparations clause.[7] This pension claim doubled the payments which Germany must make under the Treaty.

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[5] Treaty of Peace with Germany, Article 232.
[6] Treaty of Peace with Germany, Part VIII, Annex I, Section I.
[7] See address by Thos. W. Lamont in Philadelphia in 1920, widely quoted in the public press.

The Treaty stipulated that the time for payment should cover thirty years.[8] The total sum to be paid was not fixed. The German government offered a payment of 123 billion gold marks, but the French insisted they could not agree to a definite sum before they had thoroughly investigated the extent of their losses. A provision, however, was inserted in the Treaty, whereby the total payments to be made by Germany in reparations would be finally determined by the Reparations Commission on May 1, 1921.

There remained to be decided what the medium of German payments was to be. Besides payments in gold, the Treaty provides that Germany may be called upon to pay in certain real and personal property owned by the German government or by German individuals outside of Germany, and in commodities, such as ships, building material, cattle, and machinery. Germany was also allowed to charge against reparations certain property which she surrendered under the Treaty to the Allies.

The Treaty further provided that as evidence of this debt and security for it, Germany should issue to the Reparations Commission three series of bonds. The first series was for 20 billion gold marks, bearer bonds, without interest, payable May 1, 1921. The gold and commodities which Germany was to pay were to go toward the amortization of these bonds, after there had been subtracted therefrom the expenses of the Army of Occupation and payments for foodstuffs and raw materials vitally essential to the rehabilitation of Germany. The second series of 40 billion 5 per cent gold bonds was to be issued immediately, while a third series of 40 billions was to be issued only when the Reparations Commission was satisfied that Germany could meet interest and sinking fund charges.

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[8] Treaty of Peace with Germany, Article 238.

In case of voluntary default by Germany, the Allies might make economic and financial prohibitions and reprisals and in general take such measures as the respective governments might determine were necessary.[9]

Dispute Over Method of Evaluation

As the time approached for the payment of the first 20 billion gold mark bonds, on May 1, 1921, a dispute arose between the Allies and Germany: first, as to what property taken away from Germany should be counted towards making up the 20 billion of reparations due on May 1; secondly, as to the value of the commodities already delivered. The Germans claimed that the value should be appraised as of the date of delivery. The Allies declared that the value should be estimated as at the time of sale or settlement. Since there had recently been a great drop in the prices of commodities and more especially in the value of ships, it will be seen that the time of valuation made a big difference in the total sum still to be paid on May 1, 1921. Germany claimed that she had already delivered more than the equivalent of 20 billion gold marks. The Reparations Commission, however, allowed only 8 billion gold marks, leaving 12 billions still due on May 1.

Many problems soon arose for consideration, the solutions of which were not provided for in the Treaty of Versailles. Some of the Allies also complained that Germany was not attempting to fulfill the terms of the Treaty. The Allied governments have, therefore, held since the Peace Conference a series of conferences for the purpose of clarifying the issues involved in reparations and facilitating the payments to be made. At the risk of wearying and confusing the reader, we must present in brief outline the

[9] Treaty of Peace with Germany, Part VIII, Section I, Annex II, Clause 17.

history of these conferences, for in no other way can one indicate the confusion that has prevailed ever since the Peace Conference in the minds of the statesmen and experts charged with the administration of reparations. Passing by as of minor importance three conferences of the Allies, held at London, San-Remo, and Hythe during the early months of 1920, we may proceed at once to the Boulogne conference, which was held on July 2, 1920, with Great Britain, France, Italy, Belgium, and Japan officially represented.

The Boulogne and Spa Agreements

At the Boulogne meeting an attempt was made to define how much Germany should pay in goods and how much in "gold marks." It was decided that Germany should meet the expense of the Army of Occupation by payments in goods. If, however, these payments in kind should prove greater than the costs of the Armies of Occupation, then the residue was to be used by the Reparations Commission in paying any default in the further reparations requirements.

To satisfy the Belgian war debt, assumed by Germany under the terms of the Treaty and the general reparations claims, in addition to payments in kind, Germany was to pay yearly 3 billion gold marks, payable during 42 years from May 1, 1921. From May 1, 1926, to May 1, 1931, Germany was to pay a further sum of 3 billion gold marks; from May 1, 1931, this sum was to be raised to a yearly payment of 4 billion gold marks over a period of 32 years.

Germany was also to float bonds, with the aid of the Reparations Commission, in order to retire the reparations bonds provided for in the Treaty itself. These loans secured by the German government were to be a lien on property and resources of Germany, including the German customs.

Twenty per cent of these loans Germany might retire for internal use. At the end of three months she was to deposit as collateral with the Reparations Commission German industrial and other securities to the amount designated by the Commission. But a limit of 5 billion marks gold was placed on the value of German industrial securities that might be accepted. In addition, the total receipts of the German customs were to be deposited as security for the execution of this agreement, with a general receiver of German customs named by the Allies.

In case of the failure of Germany to pay the sums provided in this agreement, the securities deposited by the German government with the Reparations Commission and the total receipts of customs in the hands of the receiver would be forfeited.

Another meeting was held at Spa, July 16, 1920. At this meeting it was decided that France should get 52 per cent, the British Empire 22 per cent, Italy 10 per cent, and Belgium 8 per cent, of whatever reparations were paid by Germany. It was resolved to fix definitely the total payments to be made by Germany; and a method of reparation accounting between the Allies was agreed upon.[10]

There was a further agreement at Spa reducing the amount of coal Germany was to pay the Allies for six months to 2 million tons a month. In consideration of the impoverished condition of German miners, the Allies, on their part, were to make loans to Germany for the relief of the mining population. As France was to receive most of this coal, she was required to make 61 per cent of these loans; Great Britain 24 per cent; Italy 7 per cent; and Belgium 8 per cent.

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[10] See discussion on page 176.

The Brussels Conference

There followed on January 18, 1921, the meeting of Allied experts at Brussels. In recognition of the precarious condition of German finances, the experts recommended:

1. Payment of 3 billion marks a year by Germany for a period of five years, leaving the question of further payments until such time as the ability of Germany to pay could be more definitely determined.

2. Fixing a minimum of payments that may be made in kind.

3. Guarantees for non-fulfilment of the reparation demands by Germany, as follows:

   (a) Seizure of the customs.
   (b) Imposition of indirect taxes.
   (c) The suppression of certain government expenses such as interest and sinking fund on the German debt.

4. Allied control of the distribution of coal in upper Silesia.

5. The following modifications of the Treaty:

   (a) Limiting payments to be made now to payments in kind. It was held that a part must be paid in cash.
   (b) Reduction of coal deliveries below the Spa standard.
   (c) Continuation of contributions to support of coal miners.
   (d) The return of German property in Allied countries not yet sold.
   (e) Suppression of the plebiscite in upper Silesia.

6. Certain concessions to German demands:

   (a) Limitation of expenditures of Army of Occupation to 240 million gold marks, in accordance with the agreement of Allied Prime Ministers of June, 1919.
   (b) Simplification of the payments under Treaty of Versailles so that the German government may know the total of all payments, including reparations.
   (c) A general statement should be made that the Allies do not intend to use the terms of the Versailles Treaty to prevent the legitimate development of German trade.
   (d) Renouncing the demand made of Germany to build further tonnage, allowing Germans to keep ships not delivered for a certain number of years, or giving back to Germany for a period of years some of her shipping.

(e) Germany to be informed of the exact amount and time of each payment required of her in the future.
(f) Abandonment by Allies of right under Treaty to seize German property in Allied countries in case Germany defaults.
(g) Making exception in favor of small property holders whose possessions had been confiscated in Allied countries.

Paris Proposal

On the 29th of January, 1921, the Allied Supreme Council met in Paris for the purpose of formulating proposals for the final settlement of the whole reparations issue. It is interesting to note that they largely ignored the recommendations of the experts, made eleven days earlier at Brussels. It was decided that the total Germany was to pay for reparations should be 226 billion marks, plus 12 per cent of Germany's total exports. Payments were to be spread over a period of 42 years, as follows: 2 billion gold marks per annum for the first 2 years; 3 billions annually for the next 3 years; 4 billions annually for 3 years; five billions annually for 3 years; and 6 billions annually for 31 years. In addition to this, 12 per cent of the total annual exports was to be added to each yearly payment. These figures were officially submitted to Germany for acceptance.

At the London conference on March 3, 1921, Germany presented a counter proposal, which amounted to an immediate payment of 30 billion gold marks (the bonds to run for 72 years). This the Allies refused to accept, even as a basis for discussion, Lloyd George declaring that the reply of Dr. Simons on behalf of the German government was in definite defiance of the fundamental conditions laid down in the Treaty of Versailles. The Allies then proceeded forthwith to occupy the coal ports on the east bank of the Rhine near the Ruhr district. They also drew up a cus-

toms frontier between east and west Germany, with a view to collecting customs on goods shipped from one port of Germany to the other. The Allies also threatened to occupy the whole of the Ruhr district if Germany did not pay the 12 billion gold marks, still due, on May 1.

At this stage of the proceedings the German government appealed to the United States to intervene, as arbitrator of the reparation issue. The United States government refused, but expressed the hope that Germany would in good faith make a further offer to the Allies.

Germany then offered on April 25 a principal sum of 50 billion marks, amounting with interest over a period of years to 200 billion marks—as compared with the Allied demands of 226 billion marks plus the 12 per cent tax on exports. This offer was accompanied by numerous stipulations for the cancellation of various provisions in the Treaty of Versailles, including the return of German property in Allied countries. The offer was made through the United States, but Secretary Hughes refused to transmit it because, after consultation, it was found to be unacceptable to the Allies.

The Final Settlement

The Allies then served an ultimatum to Germany which, if not accepted before May 12, was to be followed by military occupation of the Ruhr Valley. Under the terms of this ultimatum, which was accepted, Germany must pay a total principal sum of 132 billion gold marks ($33,000,000,000). The term of years over which the payments are to be made is not fixed, and accordingly the total amount ultimately required to liquidate the account, including interest, cannot be definitely computed. The principal is, however, much larger than that called for in the Paris proposals of January, 1921; and since the ultimatum

provides for a sinking fund of only 1 per cent per annum, which will wipe out the debt in 100 years, it is by no means certain that the ultimate amount to be paid will not prove to be vastly greater than that called for by the "Paris settlement." It should be understood, however, that Germany is permitted to reduce the principal at a more rapid rate than is indicated by the 1 per cent sinking fund provision, which is in the nature of a minimum requirement.

The evidence of this reparations settlement is to be three issues of bonds: the first of 12 billion gold marks; the second of 38 billion gold marks; and the third of 62 billion gold marks. These bonds are to bear an annual interest rate of 5 per cent, with an additional 1 per cent for sinking fund, as already noted. The first series of bonds (12 billion marks) must be issued on July 1, 1921, with interest and sinking fund provisions retroactive to May 1. The second series (38 billion marks) must be issued on November 1, 1921. The interest and sinking fund on these two issues will amount to 3 billions annually. The third series (82 billion marks) must be delivered to the Reparations Commission on November 1, 1921; but it is not to be issued until such time as the Reparations Commission is satisfied that Germany is able to meet the interest and sinking fund payments thereon. It will, therefore, be seen that it is not expected that, for the present, Germany will be able to meet interest and sinking fund requirements on more than 50 billion marks.

There is an additional provision, however, which affects the amount of payments that Germany must annually make. It is stipulated that Germany must pay an annual sum of 2 billion gold marks, plus 26 per cent (of which 1 per cent is for sinking fund) of the total exports. If the annual exports should equal 4 billion marks, the total annual payment required would be 3 billion marks. just equal to 6 per

cent on the first two issues of bonds (50 billions). If the exports should be 8 billions, Germany would have to pay 4 billions' reparations; and the extra billion would be applied in settlement of interest and sinking fund on series 3 of the reparation bond issues.

For the first six months Germany is not required to pay 26 per cent on her exports. One billion gold marks will suffice. This is the smallest half-year payment that will ever be required; for Germany's exports, as we shall see in the following chapter, must be very large if she is able to pay the total reparations demanded. This first billion marks must be paid before June 6, 1921, "in gold, approved foreign currency, or approved foreign bills, or in drafts at three months on the German Treasury, indorsed by approved German banks."

This ultimatum was followed by a Cabinet crisis, and the existing German government was replaced by one that accepted unconditionally the terms of the Allied demands. In payment of the first charges Germany has already offered, and the Reparations Commission has accepted, 150 million marks in gold and foreign bills of exchange. The remainder of the first billion marks (850 millions) was paid by indorsed Treasury notes payable in three months. The first real test of Germany's ability did not, therefore, come until September 1, 1921, when the notes fell due. Germany has in fact now made the first half-year's payment in full.

Payments Already Made

Before passing to the question of German ability to meet these reparation requirements, it will be interesting to ascertain what Germany had paid to the Allies up to May 1, 1921. The following statement is taken from a report on the subject by the League of Nations: [11]

[11] League of Nations, Vol. III, No. 6, December, 1920.

German Deliveries to the Reparations Commission

17,800,000	tons of coal
19,000	tons of sulphate of ammonia
2,054,000	tons of steamers, sailing vessels, and trawlers
38,700	tons of river craft and material
360,000	livestock
6,800,000	kilos of seeds
10,700,000	kilos of pharmaceutical products
4,571	locomotives
129,500	freight cars
500,000	motor lorries
140,000	tons of railway materials
121,000	agricultural machinery, machines, and implements
	Submarine Cables: Emden-Vigo; Emden-Brest; Emden-Teneriffe; Emden-Azores (2 cables from Emden to the Azores); Azores-New York (2 cables); Teneriffe-Monrovia; Monrovia-Lome; Lome-Duala; Monrovia-Pernambuco; Constantinople-Constanza; Yap-Shanghai; Yap-Guam; and Yap-Menado.

"The above list does not include certain deliveries or cessions of a different kind, which either are, or are susceptible of, being credited to Germany, but for which figures are not yet completely determined: public properties, and parts of debts in ceded territories, the Saar Basin, material abandoned after November 11, 1918, etc. Moreover this list does not include deliveries or cessions from Powers other than Germany as provided by Treaties."

Germany has also made restitution of the following articles. By the terms of the Treaty these are not included in the reparations account.

13,560	agricultural machines
271,000	tons industrial material
407	locomotives
18,928	freight cars

In addition to these deliveries other categories of goods have been restored, such as stocks and personal property, and objects of art. The value of these has been estimated by M. Tardieu at 6½ billion gold marks.[12]

Finally, according to the report of Marshal Foch, December 31, 1920, Germany has handed over the following equipment:

41,000	cannons complete
29,000	cannon barrels
163,000	machine guns complete
2,800,000	rifles
16,000	airplanes
25,000	airplane motors

In January, 1921, the German Commissioner for Disarmament announced the collection for delivery of the following additional armament:

932	cannons
18,000	machine guns
2,000,000	rifles and carbines
78,000	revolvers

M. Tardieu estimates that the Allied and Associate Powers have received 5 billion marks of personal property in the form of German materials.[13] In addition to this the property sequestered by the Allied and Associate governments amounts to between 11 and 13 billions, and loans in foreign countries to 2 billions. This makes a total of, say, nearly 20 billion marks' worth of German property sequestered by the Allied governments. Moreover, Article 261 of the Treaty transfers to the Allies all loans granted by Germany to her allies. These are estimated by M. Tar-

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[12] M. Andre Tardieu, "The Truth about the Treaty."
[13] *Ibid.*

dieu at 12 billions. These items, taken in conjunction with the 8 billions already paid to the Reparations Commission, make a total of from 38 to 40 billion gold marks' worth of German wealth which has passed into the hands of the Allies. This, of course, does not take into account the value of the German colonies, nor of territory in Europe formerly owned by Germany that was ceded by the terms of the treaties to the Allies.

Benefits Derived

It will be interesting now to inquire how much direct and immediate benefit the Allies have received from the German territory and property surrendered, and from the reparations payments thus far made. Germany's capacity to pay reparations now and in the future has obviously been materially reduced, as a result of the loss of her colonies, of Alsace-Lorraine, of Posen, of East Prussia, etc., in addition to the Saar Valley, for a period of fifteen years. The reparations payments, amounting to 8 billion gold marks, together with the loss of personal and real property in foreign lands and of loans or investments abroad, have also reduced the annual income of Germany. It should be noted, however, that the 10 billion marks in the form of loans to Germany's allies, which was credited to the Entente, did not represent any actual immediate loss to Germany, for at no time has there been any possibility of these loans being paid.

From the point of view of the Allies, the acquisition of the German colonies, whatever advantages may possibly accrue in the long run, will afford no immediate fiscal relief. They cannot be sold for cash; nor in view of the congestion of the world's financial markets can real estate mortgages against them be marketed for cash. The acquisition of Alsace-Lorraine is as likely to prove an immediate source

of expense as of profit to France. It has already been proved that it will require a considerable period of time to develop the iron mines of Lorraine to a revenue-producing basis; and we have it on the highest authority that it has already been demonstrated that the Saar cannot now be profitably operated by France. It is partly a matter of labor output and partly a matter of distance from available markets. The loss of Posen, East Prussia, and Danzig has lessened Germany's capacity to pay; but these lands yield no new revenue to the Allies.

It is extremely doubtful whether the sequestration of real and personal property of German citizens in Allied and associate countries has aided the Allies to the extent it has injured Germany. The vast majority of the wealth of Germans in Allied countries consisted of property of German business enterprises which formed a part of the great German system of international commerce. The chief value of these properties was their function as links in the world chain of German business. When they were removed from their relationship with German commerce and industry, their chief value was destroyed. While the sequestration of this property was a loss to Germany, it added little to the earning capacity of Allied countries. These German properties had to be sold at an insignificant part of their former value as an integral part of the German business organization. The people who bought these properties frequently did so as an experiment, tempted by the low price asked.

Some idea of the nature of these sales transactions of German business enterprises in Allied countries may be gathered from the following instance, cited to us by high authority. A large rubber concern in Hanover owned a subsidiary plant near Paris. The French plant was seized during the war by government authorities and sold at an extremely low price to a French company. This French

company attempted, without success, to run the plant. Finally, after peace was made with Germany, the French management offered the manager of the parent company in Hanover approximately 40 per cent of the stock of the company if he would agree to operate the plant.

Method of Sharing

Let us now inquire which Allied nations have received the primary benefit from the 8 billions of reparations that have been taken over by them. Common justice would seem to demand that the first payments made by Germany should have gone to those belligerents which had borne the brunt of the German attack and suffered most from the consequences of the war. Such does not, however, appear to have been the case.

So far as the French share of the 8 billion marks' worth of property officially credited to reparations up to May, 1921, is concerned, it afforded little direct financial assistance to the French budget. The commodities received were for the most part used in reimbursing individuals who had suffered as a result of the German occupation. With the exception of coal, some of which was sold to other countries, comparatively little direct financial aid was given to the French government.

Moreover, astonishing as it may seem, the truth is that of the reparations funds received since the May settlement, practically none will go to France. There were 300 million gold marks, for example, in the reparations fund in July, 1921, none of which would accrue to France. To explain this seeming injustice it is necessary to state that there is a joint reparations account among the Allies under which each nation receives payments in proportion to a certain fractional arrangement. As each country receives payment in kind, that is to say, in ships, coal, etc., it is charged in

the reparations account with the value of the commodities received.

Now an agreement was entered into at Spa between France and Great Britain whereby Great Britain was permitted to value the shipping tonnage received from Germany, not at the price of tonnage at the time the ships were received, but at the price that might prevail at the time the British government should ultimately sell the ships to British purchasers. The British government made use of the German shipping so long as post-war demand for shipping persisted. After the great depression in shipping developed, the German ships were sold by the British government at an enormous reduction in price. The significance of this may be seen from the fact that Great Britain set a price of £70 per ton as the value of her own ships constructed and lost during the war, for which she claimed reparations; while under the Spa agreement the German ships received by Great Britain in reparation are valued at a selling price of only £15 per ton.[14]

On the other hand, the Reparations Commission has decided that France shall be debited in the reparations account with the entire value of the coal mines of the Saar. The decision of the Reparations Commission is legally correct, since the title to the coal mines passes to France under the Treaty. It may be added that if Germany at the end of fifteen years recovers the Saar by plebiscite, she must then pay to France the value of the coal still unmined. From the point of view of the immediate fiscal requirements of the French government, however, the decision is very bad, for it means that in the immediate future France gets no cash from the reparations account.

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[14] Rapport, Chambre des députés de la Commission de Finance Chargée d'Examiner le Projet de loi du Budget Général de l'Exercice, 1921, par L. de Lasteyrie, page 34.

CHAPTER XIII

GERMANY'S ABILITY TO PAY

Three Separate Issues

When the history of German reparations is finally completed, we shall find that there will have been three distinct issues about which the discussion has centered. They are: (1) how much Germany ought to pay; (2) how much Germany can pay; and (3) how much the Allies are, in fact, willing to be paid. We shall consider the first two of these in the present chapter, and the third in the chapter which follows.

The first of these issues may be very quickly passed over. If the principle were adopted that Germany should merely repair all the damages sustained by the Allies—if reparation rather than indemnity were accepted as the basis of a just settlement—the only question to be decided would be the exact amount of the damages that had been wrought by German aggression. The bill could then be prepared and presented to Germany for signature. But the computations of financial experts as to the total losses sustained by the Allies reached such staggering totals that it was feared Germany might not be able to pay the full amount which justice required. For example, André Tardieu, in this recent volume, "The Truth About the Treaty," [1] says:

"The figures revealed, that, if we were to insist upon the three claims—damage to property, damage to person, and war expenses—we would reach a total capital of 1,000 million (one trillion) francs, the payment of which over a

[1] Page 290.

period of fifty years would represent, taking into account interest and sinking fund, more than 3,000 million (three trillion) francs, a sum so great that it is unreal. If, faithful to this reasoning as logic demanded, we had demanded also on the ground of full and complete reparation and in accordance with full justice, payment of indirect damages, loss in operation, loss of profits, etc. . . . we should perhaps have reached some such fabulous total as 7,000, 8,000, or 10,000 billions. It was clear that if the conference was to get practical results, it would have to move only with extreme prudence."

In accordance with the dictates of prudence, the emphasis was, therefore, soon shifted from the question of how much Germany should pay, to the question of how much Germany could pay. The acceptance of this second basis of settlement led to a very substantial reduction in the amount of the demands upon Germany. But lest time should prove that Germany might eventually be able to pay more than what appeared at the moment to be probable, the ultimate amount was, as we have seen, left open for future determination.

Keynes's Estimate of Ability to Pay

It was during this phase of the reparations discussion that John Meynard Keynes, representative of the British Treasury at the Peace Conference, broke with his associates and prepared his well-known volume, "The Economic Consequences of the Peace." Keynes endeavored to show, among other things, that Germany could not reasonably be expected to pay more than a fraction of the amount the Allied estimates called for. It is unnecessary to repeat here Keynes's analysis; it is sufficient for our present purposes that he believed that Germany might conceivably be able to pay annually £100,000,000 (2 billion marks), but that

for political and other reasons it would probably prove imprudent and impractical to exact so high a figure. The aggregate amount that Germany could reasonably be expected to pay over a period of years he estimated at about 40 billion marks.

An attempted refutation of Keynes's argument is found in Tardieu's volume, to which reference has just been made. In his chapter entitled, "How the Allies Will be Paid," Tardieu seeks to prove by a citation of statistics of German wealth, production and consumption, that Germany is abundantly able to pay all that the Allies are demanding. Tardieu's eminent position as Chairman of the French High Commission to the United States during the war, and as friend and financial counselor to Premier Clemenceau, gives to his opinions so great an air of authority that it is necessary to make a careful analysis of his contentions.

The truth is that Tardieu's own figures support Keynes's rather than his own contention. But we must first see how Tardieu proves that Germany can pay. His method of analysis, in brief, is to ascertain the excess of German production over consumption before the war, and then to estimate the probable excess of German production over consumption now and in the years to come. This excess of production over consumption in Tardieu's view measures German ability to pay. Tardieu's analysis follows, in brief.

Tardieu's Calculation

German wealth before the war, according to Helffrich, a well-known German economist, was 330 billion marks, and the annual production (or gross income) was 43 billion marks—13 per cent of the national wealth. Since German consumption was estimated at 33 billion marks, there was left an annual excess of production over consumption of 10 billion marks, or about 2 billion dollars annual savings.

In computing the present productive capacity of Germany, Tardieu estimates that on account of the loss of territory and population, about one-eighth of the German productive power has been destroyed. One-eighth of 43 billions equals 5.5 billions. In addition to this there has been a loss of capital as follows:

	Marks
Personal property in foreign lands	5,000,000,000
Real property in foreign lands sequestrated by governments	13,000,000,000
Loans in foreign countries	2,000,000,000
Stocks of goods which have disappeared	20,000,000,000
Damage caused by Russian invasion of Eastern Prussia	2,000,000,000
Payments due to Allies by May 1, 1921*	20,000,000,000
Total	62,000,000,000

* Of this amount only 8 billions has, according to the Reparations Commission, been paid. See discussion on page 163.

To these figures must still be added the losses to capital equipment on account of the failure during the war to maintain it in proper condition. Of the 330 billion marks—the total wealth of Germany before the war—Tardieu deducts, before getting a basis for computing depreciation, 30 billions for urban land values, which have not depreciated, plus the 43 billions (loss of territory) and the 62 billions (loss of capital) mentioned in the preceding paragraph and table. This leaves about 200 billion marks, on which the depreciation, figured at 5 per cent annually for 4 1-3 years—the duration of the war—is 43 billion marks.

Now 62 billion marks (see table above) plus 43 billion marks (depreciation) equals 105 billion marks (total capital loss). To obtain the annual reduction in national productive power occasioned by this capital loss, Tardieu assumes that the net revenue on capital is 6 per cent. Six per cent of 105 billions equals 6.3 billions (reduction of annual production

on account of capital loss). Adding this 6.3 billions to 5.5 billions (territory loss) gives a total of 11.8 billions (total reduction in national productive power). Present production, therefore, equals 43 billions (pre-war production) less 11.8 billions (loss of production), or 31.2 billions.

In order to measure German ability to pay, it only remains now, according to Tardieu, to find out the present consumption of Germany. German consumption before the war was estimated at 33 billions. But since the loss of territory has reduced consumption as well as production, proportional allowance must be made in the consumption figures. One-eighth of 33 billions equals 4.12 billions (loss of consuming power on account of loss of territory). In addition, the standard of living has been reduced. German writers generally estimate the extent at 33 per cent; but in order to be conservative, Tardieu figures it at only 6 billions, making a total reduction in consumption of 10.12 billion marks.

Now 33 billions minus 10.12 billions equals 22.88 billions (present consumption). Subtracting this 22.88 billions from 31.2 billions (present production) gives 8.32 billion marks, the excess of present production over present consumption in Germany. This is more than ample to permit Germany to pay the 2 billion marks demanded annually, plus 26 per cent of the total exports of Germany.

Error in Tardieu's Method

Before accepting this conclusion there should be noted a vital error in Tardieu's method of computation. In figuring the total of German annual production before the war, Tardieu accepted the estimate of 43 billion marks, which, as noted above, was equal to a gross income of 13 per cent of the national wealth. But in estimating the loss of German production (gross income) in consequence

of the reduction of capital by 105 billions, Tardieu, as we have seen, discards the 13 per cent and takes 6 per cent, the net income. By this process he is able to make out that the loss of German production in consequence of reduced capital equipment is only 6.3 billions, whereas it should be 13.65 billions. In order to appreciate fully what this shift in the method of figuring annual production involves, one need merely note that if 6 per cent had been taken in computing the income on the pre-war national wealth of 330 billions, it would have given 19.8 billions instead of 43 billions, or over 13 billions less than what was actually consumed.

If we correct Tardieu's figures by substituting 13.65 billions for 6.3 billions as the loss in annual productive power in consequence of the reduction in capital equipment, we find a total reduction in annual production of 19.15 billions instead of 11.8 billions. And 43 billions (pre-war production) minus 19.15 billions equals 23.85 billion marks (present production), instead of 31.2 billions (Tardieu's figures). If present consumption is 22.9 billions (Tardieu's figures), it will be seen that Germany can pay only one billion marks annually.

M. Tardieu says: "I do not profess to be a political economist. When I quote statistics I put forward no claim to infallibility of interpretation, indeed, I am the first to call attention to the coefficient of error they may contain. I say only that when a man (referring to Keynes) goes so far as to assert that Germany cannot pay in thirty years more than 50 billion francs at par (40 billion marks), he oversteps the limits of permissible tomfoolery and is only making fun of Germany's victims." [2]

It will be recalled, however, that in estimating the reduction in German consumption, in consequence of

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[2] Page 328.

lowered standards of living, Tardieu was conservative—assuming the reduction to be only 6 billions, instead of one-third of the pre-war consumption, or 11 billions. Is he not, therefore, still warranted in his conclusion that Germany has an ample margin of production over consumption? For if 11 billions were used instead of 6 billions, the present consumption would be 17.4 billions instead of 22.9 billions.

Such would indeed seem to be the case if one could fairly assume that so great a reduction in the standard of living carried with it no impairment of productive power. Now the truth is, as Tardieu makes the most of when he is thinking of France, but does not admit when he is thinking of Germany, that a reduction in the standard of living of one-third, or of one-fifth for that matter, is certain to impair the productive efficiency of labor. The medical profession everywhere takes it as a matter of course that German productive efficiency, as measured by labor power, has been materially lessened as a result of injuries, disease, and malnutrition. Tardieu utterly ignores this factor in the German situation and concludes that the decrease in German man power will not be felt to any considerable extent.[3]

It will perhaps serve to clarify one's views in connection with this whole issue if it is recognized that if the standard of living has been reduced by one-third, it is only because the volume of wealth production has been proportionately reduced. Accordingly, one cannot assume a reduction of one-third in German consumption without first assuming a reduction of one-third in German production.

False Assumption

Having seen that Tardieu's corrected figures support Keynes's rather than his own contention, it remains to be

[3] Page 323.

shown that his entire method of computing a nation's ability to pay is fallacious and proves nothing whatsoever. The method itself is derived from a false analogy. It is reasoned that an individual's ability to pay is measured by the excess of his income over expenditures; for example, if a man's income is $10,000 per year and his expenditures $8,000, he can pay a debt of $2,000. Why is not a nation's ability to pay to be measured in the same way?

The answer is that a nation's excess of production over consumption does not consist of money which can be turned over to a foreign nation. When before the war Germany's annual production exceeded her consumption by 2 billion dollars, this did not mean that Germany had 2 billions in cash stowed away somewhere. It meant rather that there was created in Germany each year 2 billion dollars' worth of new factories, equipment, railroads, etc.—capital goods which could be thenceforth used in expanding the industrial output of Germany. New German factories, railroads, canals, highways, improved lands, and enriched soil cannot be turned over to foreign lands in payment of reparations. In fact, a relatively small proportion of any nation's ordinary savings is available as a means of making foreign payments.

One cannot therefore assume that a nation's ability to pay is measured by the excess of production over consumption. For, even if it were true that the excess was in such form that it could be sent abroad, exacting for reparation payments the entire excess of production over consumption would mean that during the time when these payments were being made Germany could not be allowed to have any increase in her domestic capital equipment. Germany would have to get on without any improvement of her demoralized transportation system, without any restoration of her mercantile marine, without any improvement of her agricultural

resources, and without any increase of factories and manufacturing equipment. Indeed, if the total excess of production over consumption were to be employed in making foreign payments, even replacement and maintenance of existing agricultural resources, industrial equipment, etc., would have to be foregone. This would of course carry with it a progressive diminution of Germany's productive capacity.

True Measure of Ability to Pay

If one is to measure German ability to pay, he must therefore find some other method of computation than that of comparing total production with total consumption. Since in the last analysis German reparations can mainly be paid only through the shipment of goods abroad, [4] the correct measure of German ability to pay lies in the possible excess of exports over imports. It will prove instructive to consider what would be involved for German foreign trade in making annual payments of 2 billion marks plus 26 per cent of the total value of German exports. The following figures show Germany's foreign trade before the war:

German imports in 1913 totaled....................	11,206,000,000 marks
German exports in 1913 totaled....................	10,199,000,000 "

The balance of 1.007 billion marks was paid for mainly by carrying foreign goods in German ships and by interest on German investments in foreign countries. It may be added that the figures for 1913 are typical for those of a number of years before the war.

In gauging Germany's ability to pay the sum demanded in the Allied terms of May, 1921, namely, 2 billion marks

[4] See discussion of this feature of reparations on pages 205-206.

annually, plus 26 per cent of the total exports, we must first consider what total Germany's exports may conceivably be expected to reach in the next few years. Since the value of gold has been approximately cut in two since 1913, prices as expressed in terms of gold being approximately double what they were before the war,[5] if Germany's export trade should in physical volume be equal to what it was before the war it would amount to about 20 billion marks. But since the productive capacity of Germany has, as we have seen above, been reduced by perhaps one-third, it is not reasonable to believe that Germany's export trade, even if no unusual restrictions are placed upon it, could be expected to exceed two-thirds of the pre-war volume—roughly 13.5 billions. Assuming this to be the total of German exports that may develop within the course of a few years, 2 billions of the amount would go for reparations payments direct and 26 per cent of 13.5 billions, or 3.5 billions, would go for reparations on account of the 26 per cent provision in the reparations settlement. This would leave 8 billions of imports to balance the international account.

Possibility of Increasing Export Balance Sufficiently

As a practical matter let us now consider whether it is probable that Germany could export year after year 13.5 billion marks' worth of goods while importing only 8 billion.[6] Before the war, as we have seen, Germany was

[5] If prices are further reduced, proportionate changes will have to be made in both export and import figures.

[6] If one prefers other figures than these, he may take, for example, 8 billion marks as the total of exports, and 4 billion marks as the total imports, which would mean reparations payments of 2 billions, plus another 2 billions on account of the 26 per cent provision. Or if one holds extravagant views as to Germany's exporting possibilities, he may assume total exports of 20 billions and total imports of 13 billions, which would yield 2 billions reparations plus another 5 billions on account of the 26 per cent provision. Whatever the amount taken, it is obvious that the reparations can be paid only by a great excess of exports over imports.

able to maintain a total volume of exports of a little over 10 billion marks (prices of 1913) by importing over 11 billion marks' worth of goods. At the present time Germany has little shipping with which to carry world traffic, and hence cannot, as heretofore, pay for imports through freight service. Moreover, Germany's investments in foreign lands have largely ceased to exist, with the result that there is no longer interest due which can be used to pay for the excess of imports. Accordingly, it would seem that Germany's imports would tend to be reduced for lack of the usual means of payment.

If in addition 2 billion marks annually, plus 26 per cent of the total exports, are no longer to be available as a means of purchasing imports, it will be seen that Germany in fact will have serious difficulty in maintaining her import trade. It would seem, therefore, altogether probable that German importations might well decline from the 11 billions total before the war to the 8 billions total suggested above. [7]

But if it turns out that Germany can import only 8 billions, one must then raise the question whether under such circumstances she may be expected to export as much as 13.5 billions, as would be required to pay the reparations. Can Germany by any conceivable means maintain a volume of exports equal to 13.5 billions when imports are reduced to 8 billions? Most of Germany's staple articles of exports can be produced at all only where raw materials, or a large part of them, have been previously imported. Germany's principal exports before the war were iron and steel, machinery, coal and coke, woolen goods, and cotton goods. With the exception of coal and coke, the exports of which have been greatly reduced because of the loss of Lorraine, importations of raw material are in every case prerequisite to

[7] For German figures for the year 1920, see pages 194-195.

manufacturing these principal articles of export. How is Germany to secure the necessary raw materials when denied the opportunity of paying for them in the usual way, that is, by means of exports?

All students of international trade and finance will doubtless agree that Germany can maintain a volume of exports such as has been suggested, only provided her total imports approach this volume. And they will also doubtless agree that such a total of imports can be secured only in case Germany is extended liberal credits by the nations which possess the necessary raw materials. Now whether Germany will be granted the requisite credits in France, England, and the United States, or elsewhere, will depend in part upon the condition of the Allied financial markets. That is to say, it will depend upon the ability of investors in Allied nations to absorb German securities at a time when the investment markets are already congested with securities growing out of war debts and the exigencies of post-war corporate financing, not to mention the reparations bonds themselves, which, as we shall see, France hopes to sell to investors. [8] It will depend even more upon American willingness—for America is now the chief lending nation—to risk funds in loans to Germany at a time when Germany is already burdened with the obligations incident to the reparations settlement. It should be remembered in this connection that German bonds would have to compete in our markets both against the bonds of other countries and against those of our own corporate enterprises. It is problematical, to say the least, whether Germany can secure the credit necessary to maintain her import trade.

One further possibility is, however, open to Germany. If in the course of time she can reorganize the industrial

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[8] See analysis on page 218.

resources of Russia, the Balkans, and the Near East, she might, over a period of years, secure there the necessary materials with which to pay large reparations.

Other Factors

While speculation as to Germany's ability to pay is interesting and informative, when all is said and done it is impossible to determine with any degree of accuracy the precise amounts that might conceivably be paid in the long run. So much depends upon factors that cannot now be gauged. The productive power of a nation and its exporting ability are not fixed merely by the number of its inhabitants, the number of square miles of territory, or the number of factories and railroads. Under favoring conditions the industrial machine by means of which national wealth is produced may attain a very high rate of output; but under unfavorable conditions the total volume of production will be relatively small. The modern economic world, as we have seen, is adjusted with very great delicacy, and in consequence, if a maximum output of wealth is to be produced, all parts of the financial and industrial mechanism must work smoothly together for the end in view. It is not enough to say that all Germany need do is to give up recalcitrancy and get down to work—produce much and consume little. The volume of work that will be available for the German population will in fact depend largely upon German ability to secure in the markets of the world the raw material necessary for her manufacturing processes, and in turn, upon having free access to the markets of the world for the sale of the excess products of her energy. [9]

Given favoring conditions with reference to credits in foreign countries, given freedom from external control

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[9] See in this connection the analysis on pages 141-144.

either in the form of military occupation or of trade restrictions, given free ingress to foreign markets in the sale of her products, given access to the economic resources of Russia and southeastern Europe, through economic alliances with those countries, and given time to rehabilitate the industrial organization of the country, Germany could doubtless pay a very great deal. That is to say, she could do so provided her financial system did not collapse under the strain to which it has been and would continue to be subjected. The German budgetary situation and the condition of the Reichsbank, discussed in previous chapters, give little assurance in this connection.

In the light of these considerations we are convinced that Keynes's estimate of a total of 40 billion gold marks as the maximum amount that Germany might reasonably be expected to pay over a period of years, is a very generous one.

Reparations and the German Budget

A word more should be said at this place, however, with reference to the budgetary situation. What will be the effect of the reparations payments upon the fiscal operations of the German government? We have seen that if Germany is to pay she must do so through exporting goods to foreign countries; for—it bears repeating—only by so doing can she derive the power to draw bills of exchange which can be handed over to the Reparations Commission for distribution among the nations which are to receive the payments. But, since it is private individuals who export the goods and draw the bills of exchange against them, some means must be provided whereby the government of Germany can get possession of these tangible means of payment. The reparations settlement provides that this should be done by taxation. It requires that the German government shall assign:

(1) the proceeds of all German maritime and land customs and duties, and, in particular, the proceeds of all import and export duties; (2) the proceeds of the levy of 25 per cent on the value of all export and import duties, except those exports upon which a levy of not less than 25 per cent is applied under the legislation of any Allied Power.[10]

It will thus be seen that reservation of the most important sources of indirect taxation are regarded as necessary for the purpose in hand; and rightly so, in view of the huge amount of the annual reparation payments that must be made. Assuming that the payments to be made amount to 4 billion marks annually, [11] let us see what this means in the way of taxes.

Four billion marks in gold represents, in terms of German currency at the present rate of exchange, some 65 billion marks. [12] This works out at a tax rate on the total German income of from 15 to 20 per cent, which alone would require as high a rate of taxation as France is willing to

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[10] This exception is of negligible importance. It had reference to the British Recovery Act of 1921, levying a tax of 50 per cent upon German exports into Great Britain. The idea involved was that the British government would collect this tax and thus get paid by the German exporter, who would have to recoup by means of an export bonus from the German government. Professor Cassell has observed that from the point of view of the German exporter this really amounted to a 100 per cent tax. If, for example, £100,000 of German goods were imported, the British government would get £50,000, leaving £50,000 to the exporter. The tax would thus be 100 per cent of what the German exporter got; that is to say, he would be taxed this amount if he could not collect it from his government. As a practical matter he could not count upon this; hence he would not be willing to export to Great Britain, unless he could add the amount of the tax to his selling price. In such cases, it will be noted, it would be the British public which would really pay the German reparations. It is considerations such as these which recently led to a reduction of the rate from 50 per cent to 26 per cent and a virtual abandonment of the entire scheme.

[11] Recall the discussion in footnote on page 186.

[12] This figure was approximately correct in June, 1921. Since then, however, the mark has fallen heavily in value and the figure is now greatly in excess of 65 billions. It is impossible for the authors to keep their figures up to date, so rapid is the fall in marks.

bear; although it is not as high as the British rate. But besides this, Germany has all her other national expenditures to meet. As previously seen, the preliminary estimates for 1921 call for expenditures of 110 billion paper marks, and revenues of 40 billion paper marks. Although these figures, as we found in the discussion of the German budget in Chapter V, are neither inclusive nor final, they will serve our present purpose well enough.

Germany may balance her budget in either one of two ways: She may increase her revenue from 40 billion to 175 billion paper marks, the amount of the present expenditures (110 billions) plus reparations (65 billions); or she may increase her revenues from 40 billions to 120 billions and decrease her domestic expenditure from 110 to 55 billions, thus leaving 65 billions for reparations—that is to say, triple her revenues and halve her expenses.

The per capita income of the United States has recently been computed at $620. The League of Nations' estimate for Germany is $103 per capita. It will be helpful to Americans, in appraising the German financial situation, to consider whether they think the Secretary of the Treasury of the United States, even with our greater wealth and relatively much lower tax burden, would find it possible to treble the national revenue and cut the federal appropriations in two, without seriously impairing the business and social morale of the country.

Reparation Paradoxes

But people read of the enormous paper profits made in Germany from both speculative and industrial ventures and still remain incredulous. The Germans, it is widely believed, were never so prosperous, never so able to pay as now. They should be compelled to restrict their purchases of luxuries, to tighten their belts and their teeth, and to save

as no people was ever compelled to save before. This sentiment is altogether laudable; but unfortunately its realization is not so simple as it seems.

In the first place, certain Allied industries do not want Germany to restrict her consumption of luxuries, which are largely imported from Allied nations. The result of German abstention from luxuries would be depression and unemployment in the Allied luxury trades. The Allies must either permit Germany to buy luxuries or suffer from the consequences. This is only one of many humorous paradoxes in the reparations controversy.[13] As a matter of fact, the reparations ultimatum requires the fulfilment of various treaty provisions, among which is the stipulation that German duties on imports of Allied luxuries shall not be increased.

In this connection it is also interesting to know that for fiscal reasons the German government has since the war created a monopoly of spirituous liquors from which very large government revenues are derived. The Allies, however, have been unwilling to allow this monopoly to operate in the occupied territory, because they have wished to sell their own cognacs and liquors there. Indeed, in direct opposition to German government policy the Allies have kept open the so-called "hole in the west" for the purpose of allowing Allied luxuries of practically every description to leak through and be sold in Germany. It should be added that in the rapprochement effected this summer between France and Germany [14] a compromise was reached as to the amount of French luxuries which Germany would officially permit to be imported. The net result will probably be an increase in the sale of Allied luxuries in Germany.

In the second place, the tightening of the belt among the

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[13] Others will be disclosed in the following chapter.
[14] See Chapter XVI.

rank and file in Germany can be accomplished only by the imposition of high indirect taxes. It is extremely doubtful whether a social democratic government can be induced to increase materially its indirect taxes when the masses of people already find their standards of living far below pre-war levels. Some increase is conceivable; but no substantial raising of indirect taxes is to be expected.

German taxes of other sorts can doubtless be increased somewhat, provided the process of inflation and profiteering continues. While the income tax rate is already up to 60 per cent on the largest incomes and cannot be increased much more, it is expected that other sources of revenue may be further utilized. The German government is now, in fact, drafting a new revenue bill. Among the added taxes being considered are: a sugar tax, a monopoly of sweetening materials, alterations of the brandy monopoly, a new corporation tax, taxes on racing bets, matches, tobacco, beer, and mineral waters, a new capital tax, an insurance tax, a further turnover tax, and a tax on power vehicles.

Germany, however, will not be able, even with these taxes, to balance her budget.

Present Ability to Pay

We have been considering the factors which will govern Germany's ability to pay over a period of years; and necessarily we have been in some degree in the realm of the speculative. In concluding this analysis we cannot therefore do better than to compute the present capacity of Germany to pay. This can be done by a citation of German foreign trade figures. German trade figures have not been published regularly since the war. But for the year 1920, according to estimates made by Sir George Paish, the well-known English authority on international trade, on the basis of data supplied by the German embassy in London,

they were approximately as follows: imports 8 billion gold marks; exports 5 billion gold marks. The adverse balance was thus 3 billion gold marks, not counting the "invisible items," which were also heavily against Germany. Under the terms of the present settlement Germany would have owed, for 1920, the sum of 2 billion plus 1.3 billion gold marks; and she could have paid none of it out of current income, that is, out of an excess of exports. On the contrary, Germany went further into debt in order to procure imports. These imports, it may be interesting to note, were largely loaned to Germany by those who were speculating in German marks.

But is not Germany just getting into her stride, and will not the volume of exports in the year 1921 greatly exceed the volume of imports? There are many stories afloat to the effect that Germany is now the most prosperous nation in the world, that her people are working like beavers twelve hours a day, that German costs have been reduced to a point where Germany can undersell her competitors in every market in the world. Investigation always shows, however, that these stories, like the accounts of Mark Twain's death, are greatly exaggerated. In consequence of continued inflation, Germany felt somewhat later than other nations the effect of the world-wide depression. But she is feeling it now, severely. The Federal Reserve Bulletin for May, 1921, contains a summary of conditions in Germany which shows an increasing volume of unemployment and increasingly disturbed business conditions. The following summary statement relating to Germany, taken from Cox and Company's (English bankers) monthly review of business conditions for May, is conclusive:

"The uncertainty of the political and economic outlook accentuates the unfavourable conditions in trade and industry. The metal and engineering industries report a

substantial set-back. The Metal-Workers' Union, which embraces approximately 2,000,000 members, states that at the beginning of May more than 10 per cent had been out of work or put on short time. In the electrical industry the unsatisfactory financial status of the 'Reich,' the Federal States, and of most large municipalities, makes itself more and more felt in the lack of large orders for new plants and engines. Only motor construction has a comparatively good stock of orders on hand. With the exception of some specialties, the chemical industry likewise reports a slowing down. The shoe industry is one of the few branches which are at present enjoying good times."

If more is needed to convince the doubting ones, it may be found in the British *Board of Trade Journal* for June 16, 1921, which concludes a summary of conditions in south Germany, as follows: "The picture of Bavarian industry as a whole is one of deep gloom and uncertainty as to the future."

There appears, however, to have been a little improvement in July, attributable primarily to an increase of subsidies designed to stimulate exports with a view to meeting reparation payments.

German Competition

Much has of late been said of Germany's ability to produce goods so cheaply that German competition in world markets is certain to prove utterly ruinous to Allied industries. In so far as Germany's foreign trade has been receiving an impetus, it is largely attributable to subsidies. For example, the railroads of Germany were last year conducted at a deficit of more than 9 billion paper marks, to the end that freight rates might be kept down and trade thereby stimulated. In similar fashion, German ship-owners have been granted large subsidies as compensation for their ton-

nage which was seized for payment to the Allies. The government has bound the ship-owners to complete in German shipyards within the course of five years 2½ million tons of shipping, i.e., one-third of Germany's former mercantile fleet. Coal and raw materials prices are also kept down by law in order that the cost of production may be low, and it has also been found possible to keep wages down by controlling the price of bread. But all these efforts to stimulate trade are artificial, and the consequences are manifested indirectly. All subsidies must be shouldered by the government; and they thus indirectly fall back upon the masses either in the form of taxes or further government deficits that require additional resort to the printing press. The price that Germany pays for her relatively lower costs of production is progressive demoralization of the financial system.

It is true, as we have seen in the chapter on foreign exchange, that the great depreciation of the mark makes Germany one of the best markets in the world in which to buy. This is because the increase in money costs of production in Germany does not quite keep pace with the fall in the value of the mark. This "lag" is, however, in the main attributable to the subsidies just mentioned. Just as soon as subsidies are discontinued and the real costs of production are placed where they belong, the export advantage now enjoyed by Germany will in large measure disappear. It will also disappear [15] as soon as the German financial system breaks down under the strain to which present financial requirements are subjecting it. Even as it is, Germany is reaping no great advantage from the situation.

[15] It may not wholly disappear, however; Germany still possesses an advantage as compared with the Allies insofar as she can import materials from countries to the east, whose currencies are depreciated even as compared with her own, and export to countries whose exchanges are at a premium.

There have been repeated difficulties of late in making deliveries at the prices agreed upon in desperation; the rapid mounting of prices continually has upset the cost computations of manufacturers. The figures of German exports, moreover, show conclusively that Germany is not profiting much from this condition, because of inability to import the necessary raw materials and inability to produce in excess of necessary domestic requirements. According to present indications, Germany's exports in 1921 will not greatly exceed those of 1920, and will still be materially less than the total of imports.

How Germany is Now Paying

But Germany is already paying, it is answered; there is obviously something fallacious in theories of German inability to pay, put forward in the face of the incontrovertible fact that since the German government accepted—under the threat of Allied occupation—the terms of the May ultimatum, reparations payments have been met promptly and in full. Moreover, has not Dr. Walter Rathenau, the German Minister of Reconstruction, officially admitted that Germany can and will meet the obligations imposed upon her?

With reference to the Rathenau statement, it must be remembered that the previous German government fell because of its refusal to concede the possibility of making the payments demanded. Dr. Rathenau accepted his post under a new government whose declared policy—one might say whose only policy—was to make every effort to fulfil the reparation demands. Under these circumstances one would hardly expect that his first official announcement would be that Germany could not pay. The obvious intention in his announcement that Germany could and would pay was to convince the Allied governments that a bona

fide attempt to meet the terms of the settlement would be made. Incidentally, it may be noted here that M. Briand himself was among the first courageously to recognize, in the face of bitter parliamentary opposition, that the new German government was honest and sincere in its efforts to fulfil the terms of the Allied demands.

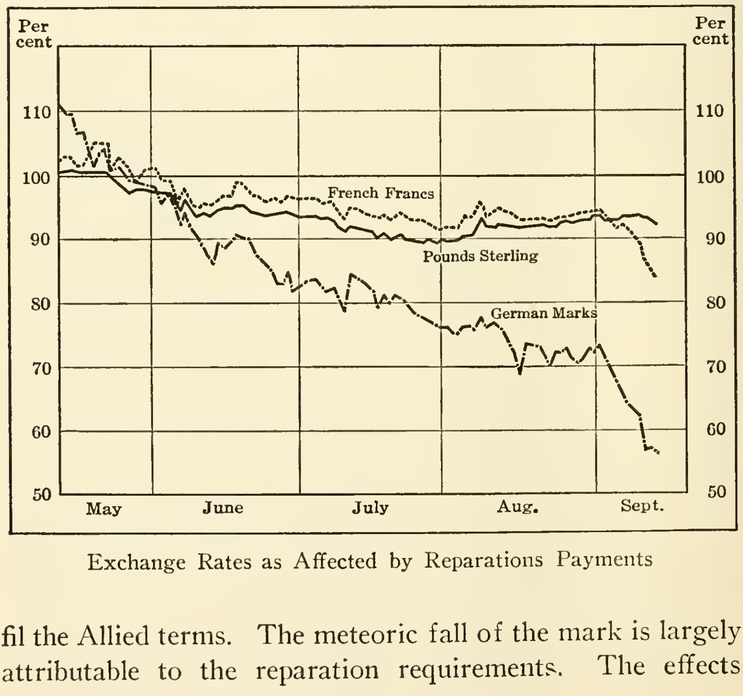
Now let us see precisely how the German payments since May, 1921, have been made. As shown in Chapter XII, the ultimatum required a payment of one billion gold marks for the first half-year, the 26 per cent requirement being omitted for this period. By June 6, Germany, as required, had paid the equivalent of 150 billion gold marks and given three months' Treasury notes for 850 billion gold marks, due September 1. This latter sum was paid in full on that date.

These sums have not, however, been paid out of income, that is, out of an excess of exports over imports. They have been paid in the main out of capital and through new borrowing. Concretely, Germany has met these payments mainly in the following ways: (1) by mobilizing remnants of investments and assets owned in various parts of the world; (2) by selling paper marks wherever naive speculators therein could still be found; (3) by negotiating loans in Holland, England, and the United States. These resources did not, however, prove sufficient to meet the September payments. Although the printing presses were worked overtime and the government poured out paper money like water, 3 billion marks being added to the outstanding note issues of the Reichsbank in the last week of August alone, it was in the end found necessary to cut into the already hazardously slender reserve of the Reichsbank and part with 68 million marks in gold.

Each of these means of payment is a rapidly diminishing and quickly exhausted one. Indeed, the desperate expedient

of utilizing Reichsbank gold reserve is evidence that all other means were exhausted in August. None of them can be counted upon again to furnish any substantial sums. The entire remaining gold supply of Germany is not sufficient to meet the next half-year's payments of one billion gold marks, plus 26 per cent of Germany's total exports. If the gold is used, moreover, German financial collapse within the year is assured. If it is not used nothing is more certain in this uncertain world than that Germany will be in default on the payments to which she is now committed within twelve months.

The accompanying graph shows the fate of the German mark since May 8, the date on which Germany agreed to ful-



Exchange Rates as Affected by Reparations Payments

fil the Allied terms. The meteoric fall of the mark is largely attributable to the reparation requirements. The effects

upon Allied commerce and industry of such violent gyrations of the exchanges will be discussed in Chapter XIV.

It is contended that if Germany only ceased printing paper marks with which to meet reparations, and resorted instead to an internal bond issue, the reparations could be paid without serious difficulty. The borrowing fallacy thus crops up again. If the government sells additional bonds at home, it merely increases the total interest to be paid, and its deficit will be further increased. Moreover, the sale of government bonds carries no assurance that the volume of currency would not be increased. For the buyers of the bonds would undoubtedly borrow a considerable portion of the funds from banks, as was done in every country during the war. This may be the lesser of the evils; but it is no solution of the problem. Recent attempts to place the credit of great industrial interests back of the government have the same point of weakness. Finally, assuming the government thus gets funds, the problem of securing an excess of exports over imports still remains the fundamental difficulty.

Could Britain Pay the Reparations?

Official statistics of Great Britain's foreign trade and financial operations prove that even she could not pay out of current income the amount of the German reparations. The data which follows are for the calendar year 1920.[16]

Trade Items		"Invisible Financial Items"	
Imports of merchandise	£1,936,800,000	Interest from foreign investments	£120,000,000
Exports of merchandise	1,558,000,000	Income from shipping services	340,000,000
Excess imports of merchandise	£378,800,000	Profits from banking and other services	40,000,000
Excess of exports of bullion and coin	43,500,000		
Excess of imports	£335,300,000	Total "invisible items"	£500,000,000

Net balance in favor of Great Britain £165,000,000

[16] Data taken from London Joint City and Midland Bank, Ltd., *Monthly Review*, February, 1921, page 2.

Now £165,000,000 equals 3.2 billion gold marks.[17] Under the terms of the reparations settlement there must be paid each year 2 billion gold marks plus 26 per cent of the total exports. Since Great Britain's total merchandise exports were £1,558,000,000, or roughly 32 billion gold marks, the total indemnity would have amounted to 10 billion gold marks. Great Britain had 3,200,000,000 marks of net favorable balance with which to pay 10 billions of reparations. Add to this the total gold supply of the Bank of England, approximately 2.5 billion marks, and Great Britain could have paid only about 60 per cent of the year's requirements. Moreover, in view of the business boom and the skyrocketing of prices, the year 1920 was, in terms of money values, as good a year as England may expect to have in a generation.

Great Britain, it is true, could have paid the amount out of capital—through the utilization of foreign securities for the purpose. Such a procedure, however, even in the case of Great Britain, would quickly reach an end. Resort to it would, moreover, rapidly reduce the balance in Britain's international income account out of which subsequent annual payments would have to be made. Income alone constitutes a permanent source of reparations. And out of income Great Britain herself could have paid in the excellent year 1920 only about one-third of the requirements imposed upon Germany.

[17] This is on the assumption that sterling was at par. Since sterling was depreciated about 25 per cent, the amounts that Britain could pay are here somewhat exaggerated.

CHAPTER XIV

HOW MUCH ARE THE ALLIES WILLING TO BE PAID?

Means of Payment

In all the voluminous discussions of the reparations issue there has been the greatest confusion of mind as to what is involved in the payment of reparations. On the part of both Allies and Germany official attention has always been centered upon the amounts to be paid, and these amounts have always been expressed in terms of money. The implication has almost always been that Germany is to pay the reparations demanded primarily with money, just as individuals meet their obligations by a transfer of money. In the official discussions of reparations the truth has never been set forth, either by the Allies or by Germany, that only an infinitesimal part of the total sums under consideration could possibly be paid in actual money.

While the Treaty of Peace stipulated that certain property and goods, such as ships, coal, cattle, rolling stock, etc.,[1] should be surrendered by Germany, and while there have been treaty provisions and suggestions that Germany should furnish certain materials for the reconstruction of the devastated areas, the contemplated payments in kind constituted but a mere fraction of the total sums stipulated. The greater part, it was thought, should be paid in money or funds. Evidence of this contemplation is to be found in the history of reparations. The controversies have all centered around the question as to whether Germany should

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[1] See list of payments in kind on pages 171-172.

in justice be compelled to do more than provide for the physical reconstruction of devastated areas; whether she should not be compelled to provide money for Allied pensions and for defraying the entire costs of the war. The argument is that Allied budgets are to be relieved by the receipt of German reparation money.

The experience of the Reparations Commission and Allied governments with the practical administration of reparations during the last three years has developed two distinct and opposing doctrines. In the first place, it has partly dawned on the statesmen of Europe that somehow or other it appears to be necessary to allow Germany to pay at least a considerable part of the reparations demanded in commodities. We say that this has "partly dawned" on the statesmen of Europe for judging from their public utterances the mists have even yet not entirely cleared away.

In the second place, it has apparently fully dawned upon these statesmen that the business interests within their respective countries are not disposed to permit Germany to make any considerable payments in the form of goods. The net result of these two opposing tendencies is the insistence by the Allies that Germany shall pay the huge totals demanded, under threat of further military occupation, and the adoption of means to prevent the importation of German goods, with which alone Germany can pay.

It should be stated at this point, however, that since the May "settlement" of this year, a plan has been evolved whereby it is believed France will receive a part of the payments due her in materials for reconstruction of the devastated areas. This development will be discussed in detail in the following chapter. Meanwhile we shall consider the situation as it existed until May last, and as it still, in the main, exists. We say "in the main" because the contradiction still pertains to the payment of about half the

French share, and to all that of the other countries, amounting to over 70 per cent of the total. Moreover, the plan whereby France is to receive one-third in reconstruction materials is apparently to operate for only a few years—until the devastated areas have been repaired.

In the present chapter we shall show why Germany cannot pay in money, and why there is no possible means of payment other than by exporting more commodities than are imported. We shall also indicate why the Allied nations are not willing to permit Germany to pay in the only way that it is possible for payment to be made.

Inability to Pay Money

Germany cannot pay more than an infinitesimal part of the obligations imposed upon her by shipping gold to the Allies. Practically all of the German gold supply—as is the case in other countries—is now concentrated in the central bank. Gold in private hoards, if there be any such, may be disregarded because of the practical impossibility of collecting it. Now the total gold supply in the Reichsbank at the present time is 1,091,000,000 marks, or about $260,000,000. Since Germany is required to pay 2 billion gold marks annually, exclusive of the 26 per cent tax on exports, it will be seen that the entire gold supply of Germany would suffice to meet the minimum obligations for a little more than a half year. And having paid it out once it is obvious that Germany could not use this gold in making any further payments. Moreover, since Germany produces no gold, any addition to her gold supply can be secured only by exporting commodities.

The utter impossibility of paying huge international obligations in actual gold may be seen from the fact that the total production of gold in the world is annually now only about $300,000,000 and that the total world produc-

tion of gold since the discovery of America has been less than $18,000,000,000, about half of which has been lost or destroyed. Of the amount in existence, the United States has about $3,000,000,000 in the form of gold coin and bullion, Great Britain about $650,000,000, and France about $1,000,000,000. In the light of these simple statements of fact, it is clear that international debts can be paid only to a very small degree by shipments of gold. Still less can be paid in silver—Germany, for example, having only a few million dollars of the white metal.

Not only is it impossible for Germany to pay more than 1,091,000,000 marks of the debt in gold, but if the Allies are interested in further payments Germany should not be permitted to part with her existing gold supply. For this meager German supply of gold is the only support to the more than 80 billions of paper currency now outstanding. If the Allies wish to precipitate a financial collapse in Germany, they have only to demand that this gold be used in payment.

One may ask, in the light of these facts, why the official statements always say that Germany must pay so many gold marks per annum? The explanation of the term gold marks is not that the Reparations Commission expects that the debts are to be paid in actual gold; it merely insists that the value of the debts shall be reckoned in terms of gold rather than in terms of depreciated paper money.

If Germany cannot pay in gold, can she not use other forms of money for the purpose? The answer is that she can pay nothing outside of her own borders with paper money. No nation will accept in the settlement of international obligations of any kind the fiduciary paper currency of another nation. Gold is the only currency that is acceptable in settling international debts—and even this only by weight and fineness. Gold is the international money.

German Labor Not Acceptable

If German reparations cannot, therefore, be paid in gold, in what are they to be paid? There are several possibilities to be considered. In the first place, it has been suggested that German labor might be sent into France for the purpose of making a physical reconstruction of the devastated areas. This means was in fact proposed by the Germans themselves at the Peace Conference. But the French representatives at that time refused to accept the suggestion, on the ground that French labor was opposed to the competition in their own country of imported German labor. Moreover, have they not seen enough of German invaders for one lifetime?

The offer has nevertheless been recently repeated by the Germans; and the final terms of the settlement do in fact make it possible for the Allies to call upon German labor as needed. But thus far no call has been made; nor is there likely to be any demand for German labor. The only practical suggestion that has been made is that German labor be utilized in constructing French highways and in planting trees along those highways. Such work, it is very true, would offer no competition to French labor; but neither would it relieve the burden under which the French Treasury is laboring.

France boasts that she has already effected the reconstruction of a considerable part—approximately 50 per cent—of the devastated regions; and that she is willing to undertake the reconstruction of the rest. What France wants is not German labor, but payment for the work which French labor has already performed and is willing to perform in completing the task of reconstruction. Neither France nor Belgium is willing to permit more than an infinitesimal fraction of the total reparation payments to be made by German labor.

Payment in Goods

A second means theoretically open to Germany of reimbursing France is by the shipment of commodities into France. These might be composed of materials necessary for reconstruction purposes, machinery and equipment for factories, etc., and goods in form for consumption. But here again we find that France has not been willing to receive such commodities, save in limited quantities.

We have already seen that some commodities have been received by the Allies, such as ships, coal, rolling stock, livestock, etc. But we find that the amounts of these commodities that are acceptable have been strictly limited.[2] It has been many times suggested that Germany should furnish the materials necessary for the reconstruction of northern France. Having destroyed this region, what could be more just than that Germany should provide the materials for its restoration? Surely France would welcome this means of payment, whatever its attitude towards the utilization of German labor for reconstruction purposes.

In this connection it is important to recall that the Peace Treaty provided that Germany should devote her economic resources directly to the physical restoration of the invaded areas. Concretely, Germany was to furnish animals, machinery, equipment, tools, and like articles of a commercial character; also reconstruction materials, stones, brick, tile, wood, window glass, steel, lime, cement, furniture, and heating apparatus.[3] The commodities included in the list represent the German products which at the time of the Peace Conference the Allies had selected as those they particularly desired from Germany.

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[2] These provisions are found in the annex of the reparation clauses.

[3] For a discussion of the effects upon the Allies of the receipt of German coal and ships, and of the final refusal to receive any more ships, see pages 227-229.

Within three months of the signing of the Treaty the Allied governments handed to the Reparations Commission a list of materials which they wished to have delivered by Germany. The list was composed of wood, textiles, paper, construction material, industrial tools, metal construction, etc., to a total value of over 13 billion francs. This request was submitted to Germany. As usual Germany delayed answering for a considerable period of time, and, after long dispute with the Reparations Commission, sent in a list of commodities which in considerable measure conformed to the Allied demands. The French government, however, then decided not to accept the German materials offered, partly on account of the high prices which were to be charged against the reparation account for these commodities, and partly because of the effects of the competition of German goods on French industry. The report of the Commission on the French budget for 1921, published March 1, 1921, says of these negotiations that while the Germans showed bad faith in fulfilling their agreements, the French Commission showed a lack of energy in enforcing them. "In some cases they were restrained by the fear that the German products would compete with our own goods."

The truth is that while the French have all along appeared to be willing to admit reparation payments in commodities, still when the point is reached where an actual agreement for delivery must be made, French industries themselves bring pressure to bear against accepting the German commodities.

Fear of Effects of Reparation Payments

The proposed use of German materials for the construction of houses in the devastated areas is most illuminating. Since wood was the only building material that France could not readily furnish for herself, it was suggested by the

Germans that they furnish 25,000 wooden houses. But the Builders' and Public Works Contractors' Association of the "Nord" (the department that suffered most from the war) immediately drew up a long indictment of the proposal. A vehement protest was made against "the entry into France of materials worked up by German labor to the detriment of French workmen and contractors." Objections were also raised to the principle of substituting wooden dwellings for the customary stone and brick. At the most Germany should not be allowed to furnish houses costing in excess of 8,000 francs. [4]

There is also a sentimental reason against allowing Germany to construct French houses. The French peasant and workman returns to the site of the old home and desires himself to oversee its reconstruction with a view to making it a replica of former days. All that this home-rebuilder wants is pay for his losses—pay in the form of cash.

It has been the same story with machinery. Under the terms of the Peace Treaty, France was given the right to call upon Germany for any machinery required. John F. Dulles, Counsel to the Peace Commission, is authority for the statement that France has never called for a single piece of German industrial machinery. The explanation is that French manufacturers wish to supply this machinery. Moreover, if Germany were allowed to supply the machinery necessary for the rehabilitation of French factories, it is feared that the Germans would gain a permanent control of the market, because of the necessary standardization of machine parts.

If other evidence is needed to show that France is unwilling to receive German goods in quantity, it is to be found in recent increases in French tariff duties, aimed

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[4] This is taken from the *Economist* (London), June 18, 1921.

especially at imports from Germany. A statement of Premier Briand before the French Chamber and Senate on February 3, 1921, quoted on page 250, further confirms the conclusion that France is fearful of the effects of reparations payment on her own industries.

The Royal Game of "Passing the Buck"

We have thus far seen merely that France [5] has been unwilling to be made the "goat" in this matter of reparations, by having her own industries subjected to German competition. Are there not roundabout means, however, whereby France can be paid without the threat of injury to her own industrial organization? Cannot Germany export the goods to other countries, draw bills of exchange against them, and turn these over to France in settlement of reparation obligations? This suggestion, as we shall see, has given rise in the field of international economics to the well-known game of "passing the buck."

One possibility is for Germany to export her goods to Great Britain and turn the resulting bills of exchange over to France. But Britain is alarmed lest this result in the destruction of her own industries; and she has constructed an anti-dumping tariff bill designed to keep German goods out. When it is considered that Germany's principal articles of export—coal, iron and steel, machinery products, and textiles—are also England's principal products, this concern is not difficult to understand.

Incidentally, it may be noted that even if France were willing to receive German goods directly, Great Britain would find it to her disadvantage, since her continental markets would be restricted to that extent.[6] Similarly, in the course of time France would find German sales in other

[5] The analysis applies equally to Belgium.
[6] See discussion on pages 227-229.

countries disadvantageous because of the effects upon French exports.

If England is unwilling to receive German goods, can we not nevertheless expect the United States to hold the bag? Is the United States willing to receive German iron and steel products, chemicals and dyestuffs, coal, machinery, and textiles, in order to permit Germany to draw bills of exchange which can be used in settling reparations? The best evidence lies in the existing Emergency Tariff Act and the permanent high tariff bill now before Congress, aimed directly against the threatened invasion of the American markets by European goods. Clearly the United States—at least official United States—is not willing to be the "goat."

European Debts to the United States

At this juncture the question of European debts to the United States forces its way into the problem. Is the United States any more willing to have Europe pay her war indebtedness than she is to receive the goods with which Germany is to pay reparations? The perfectly plain answer again lies in the recent tariff legislation. Goods alone can be used in paying these debts, just as shipment of goods abroad during the war was the only means of creating them. Merely to pay the interest on these debts will necessitate our having an excess of imports over exports of about $700,000,000 annually. The United States, as the world's greatest creditor nation, has troubles enough of her own, without bearing the brunt of the burden of receiving reparations.

But at this point those who cannot admit the cruel suggestion that the payment of international debts, however rapid and however great in volume, could possibly be undesirable from the point of view of the recipient, shift their thoughts hopefully to other markets. "International debts

can be settled by roundabout processes." It is often argued that just as England in the days before the war conducted her vast international commerce in roundabout ways, and thus found no embarrassment in being a creditor nation, the United States can now avoid being paid directly.[7] Let Europe ship the goods to South America and send us bills of exchange in payment. With these bills we could then buy coffee and rubber in South America free of cost to us.

There are just two objections to this argument. In the first place, the volume of goods which South America can purchase from Europe is negligible as compared with the volume of reparation obligations and Allied debts. In the second place, in view of the decline of her export markets in Europe, the United States is turning with renewed determination to the capture of South American markets. The most promising outlet for our excess manufacturing capacity is there. We may not, indeed, be able to secure large southern markets in the face of British, French, and German competition; but this is another matter. Our desires and needs are clear enough. It may also be observed that Great Britain and France are no more willing to see Germany capture the South American markets than is the United States. And incidentally, France and England would not be altogether pleased to see German goods underselling their own in North American markets.

Supreme Inconsistency

If South America is out of the question, then what of Poland, Russia, and the Near East? Those huge, undeveloped regions, it is argued, will require stupendous quantities of materials during the next forty years. Is not here Germany's opportunity to provide the means, through ex-

[7] For a discussion of England's position as a creditor nation, see page 312.

ports, of paying the Allied debts to the West? At the time of the Peace Conference this issue was raised with a high French official in France by a well-known American economist. The French reply was that France was not willing to allow Germany to gain a foothold in eastern European markets; French exporters were casting covetous eyes in that direction themselves, and German competition must be prevented.[8] The French may not be able to keep Germany out of these markets; but that again is another matter.

As regards Polish trade with Germany, it is not without significance that France has recently concluded a secret treaty with Poland, which gives French traders certain exclusive privileges. Incidentally, once more, it may be added that Great Britain and the United States are no more willing to see Germany capture the eastern European markets than is France. "When Russia comes back" these great manufacturing nations count upon furnishing the materials necessary for the industrial rehabilitation of that unhappy land.

When this stage of the discussion is reached, he who persists in the belief that the Allies really want reparations paid in full makes his final stand with China. When that slumbering giant of the East awakens, cannot German reparations be paid through shipments of goods there? Think of the illimitable demands for oriental products when once the Celestial Empire enters the fold of industrial civilization! In view of recent events in China, however, one need not be very sanguine with reference to Chinese purchasing power in the near future. And as for the longer run, the story of the international banking consortium for the extension of credit for Chinese development is indica-

[8] See an article by Professor F. W. Taussig, in the *Atlantic Monthly*, March, 1920, entitled "Germany's Reparation Payments."

tive. Five nations were originally represented in this consortium: Germany, Japan, France, England, and the United States. Since the war Germany has been thoughtfully excluded.

The simple truth is that the insistence of Allied nations that Germany must pay to the limit of her capacity is the supreme inconsistency of the ages. At the very time when the governments of all the Allied nations are demanding that Germany pay in full, under threat of military penalties, one can scarcely pick up a trade or financial journal without reading accounts of the menace of reviving German competition in all the markets of the world. The great fear stalking throughout the commercial world today is that Germany may come back as a powerful competitor in the international markets. In view of our analysis in previous discussions of the German banking and monetary situation and of German capacity to pay, it is clear that this fear is very greatly exaggerated. But it none the less evidences the determination of the Allied nations, the United States included, not to permit Germany to pay if they can help it.

Other Suggested Means of Payment

We would deem it unnecessary to pursue the reparations issue further, had experience not convinced us that men simply will not give up hope that some way out of the dilemma may be found. Germany simply must not be let off with a whole skin! It cannot be true that France must in the main herself bear the burden of her war losses, and the cost of her own reconstruction! The suggestion outrages every principle of justice! It will serve to clarify the remainder of the argument if the questions that have been raised in informal discussion with many persons both in the United States and abroad, be here definitely stated and definitely answered.

1. *Cannot Germany pay by turning over to France the securities of German corporations?* [9] This proposal was, in fact, once made by Germany. It was, however, refused by France, on the ground that it would too vitally interest the French people in German industrial prosperity, to the possible future political and economic disadvantage of France. But in any event, transferring to France stocks and bonds of German corporations would not solve the dilemma. It would merely shift the responsibility for paying from the German government to German corporations. How would the interest and dividends on German securities be paid to France? German corporations can pay interest and dividends only in paper marks; they have no gold with which to pay. And German paper marks are practically worthless in France. In order to obtain acceptable means of payment, the German corporations would therefore have to export goods against which bills of exchange might be drawn. Once more—if Germany is to pay—somebody must be willing to receive German goods.

2. *Cannot German corporations be compelled to turn over their dividends to the German government, and thus permit the German government to pay France?* We are again exactly at the point where we started. The German government is to pay France by getting the means from the German people. But there is insufficient gold with which to make these payments, and the only way open is to ship goods against which bills of exchange may be drawn. Who will accept the goods?

3. *Cannot the Allies be given the ownership of future rather than of present German corporations, or, better still, of future Russian industries, built up as a result of German exports to Russia?* It is difficult to see how the ownership

[9] Foreign securities need not be considered, since the quantity still owned by Germany is negligible.

of future German, or Russian, industries will prove any more satisfactory than the ownership of present German industries. One would imagine, moreover, that if this ownership were to bring tangible benefits to the citizens of the Allied nations, it would be through the receipt of interest on their investments in such industries. Once more, how is this interest to be paid, if not in goods? And who is to receive the goods?

4. *Cannot the Allies seize German cities and collect customs and other revenues in satisfaction of indemnity claims?* This is not an academic question, merely. It has already been an official policy on the part of Allied governments. In the ultimatum submitted to Germany in March, 1921, there were laid down in the most solemn language which statescraft could devise the means of collection that would be employed in case the Germans refused longer to "disgorge."

"Unless it transpires by Monday next [reads the Allied ultimatum] that Germany has decided to execute the agreement of Paris of the twenty-ninth of January, 1921, or to submit proposals which will permit her to fulfill by other means equally satisfactory the obligations incumbent upon her under the terms of the Treaty of Versailles, with reservations concerning the concessions granted at Paris, we will take from the date named the measures herein mentioned:

"The Allies are in accord in the decision that the cities of Duisburg, and Düsseldorf shall be occupied . . . That all customs duties collected on the exterior frontiers of the territories occupied shall be paid into the Reparations Commission. That a line of customs houses shall be provisionally established on the Rhine and at the limit of the bridgeheads occupied by the Allies. That the duties to be collected on this customs line—whether export or import—shall be fixed by the High Inter-Allied Commission of the Rhenish territories, in agreement with the Allied governments."

When the Germans failed to come to terms, moreover, Allied armies marched resolutely into Germany, seized the Rhine cities of Ruhrort, Duisburg, and Düsseldorf, and made ready to collect as any creditor armed with legal sanctions might do. With supreme, though apparently unconscious irony, M. Tardieu asks in his book, "But has anyone observed that we have been able to collect a single franc?" The reason is that German customs duties and other taxes are, of necessity, paid in paper marks. And continental paper money—east of the Rhine—is no longer "worth a continental." No guaranty would be of any value except a claim to German goods; and this is regarded as valueless, because nobody wants the goods.

5. *Cannot France receive payment through the sale of reparation bonds for cash?* There is one possibility by means of which particular Allied nations might conceivably receive benefits from reparation payments at the expense of other nations. France has in fact been counting heavily upon this device. When the German reparation bonds are received, France hopes to sell a considerable part of her allotment thereof in the world's investment markets—which means, under present conditions, principally in the United States. The condition of the French budget, as we have seen, is desperate. France hopes through the sale of reparation bonds to improve materially her financial status.

In considering this phase of the problem it should be understood at the outset that France does not expect to turn over to the United States reparation bonds in liquidation of her existing debts to us. Since France is not paying interest on her debts to other governments, no help to the French budget would come from a substitution of reparation bonds for French government obligations. Interest is being paid, however, by the French people on private obligations in the United States, which amount to approximately

$1,000,000,000. If France could sell reparation bonds in the United States sufficient in amount to offset these interest charges, that degree of help would obviously be given to the French budget. It will be observed, however, that at best this is negligible—amounting to only 250 million francs as against an estimated deficit of 35 billion francs.[10]

Moreover, what France is much more likely to insist upon is the opportunity to sell reparation bonds as a means of buying necessary goods in the United States. In other terms, this means giving France additional credit. To the extent that France could dispose of these securities in the United States markets it would clearly strengthen her financial position.

But what is the chance that investors in the United States will be willing to buy German reparation bonds? There is little probability that we should be willing to buy them at all without French indorsement, which means that we would really place our faith in France rather than in Germany. In effect it would therefore mean that France's own obligations would thus be increased, and her financial position would therefore be improved but little if at all.

It is the general belief in American financial circles, moreover, that reparation bonds could not possibly be marketed in the United States at a better price than 50 per cent of par. It is the further belief that no great quantities could be marketed at any price at the present time or in the near future. This is partly because of the enormous supply of investments of better grade that are available for our markets, and partly because of the enormous risks attaching to the reparation bonds. Other foreign governments are continually seeking to place loans in the United States, and in addition we must absorb large issues of American

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[10] See analysis of the French budget, pages 49-54.

governmental, municipal, railroad, public utility, financial, commercial, and industrial securities. Our investment power is limited; and investors may be expected to choose with a view to securing a maximum of yield with a minimum of risk.[11]

Before investing in reparation bonds the American people should, moreover, clearly appreciate that—wisely or unwisely—our government policy is designed to make it impossible for Germany to pay interest on reparation bonds. For in this matter of the sale of reparation bonds by France to the United States we tie right back to the preceding analysis. The nations which buy the reparation bonds will have to get their pay by means of German exports. If we buy German reparation bonds and expect to receive interest thereon, we must agree to receive the German goods which France is unwilling to accept. The emergency tariff should cause every American investor to shun reparation bonds as utterly valueless securities.

The conclusion with reference to the sale of reparation bonds in the American market is therefore twofold: first, it could not at best be relied upon to bring much financial help to France; second, American investors should refuse to purchase such bonds so long as the American government refuses to allow Germany to send exports freely to this country as a means of payment.

Whatever the theoretical possibility that some particular nation might obtain fiscal relief through the sale of reparation bonds, as a practical matter the suggestion that German reparation bonds can be effectively utilized by the nations receiving them is of no value. No nation and no group of investors is willing to invest any appreciable sum in reparation bonds. And of far deeper significance is the inescapa-

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[11] For further discussion on this subject, see Chapter XX.

ble fact that no Allied nation is willing to permit Germany to pay interest on reparation bonds, in the only way possible, i.e., by expanding exports.

In conclusion, the nature of the reparations dilemma cannot be better epitomized than in the words of a well-known Anglo-Saxon business man: "We believe Germany should be forced to pay; we doubt whether she can pay; but if we find that she can, by jingo we won't let her."

CHAPTER XV

THE ECONOMICS OF THE REPARATIONS PROBLEM

Reparations and Free Trade

It is clear enough, then, that the Allies are unwilling to receive any great volume of German reparations. The refusal to call for goods under the rights given in the Treaty, the imposition of heavy tariffs against German goods, together with the prevalent fear throughout the commercial world of a revival of German competition, afford conclusive evidence on this point. While the facts are thus undoubtedly as stated, is not this refusal of the Allies merely a bit of stupid protectionism? If only the statesmen knew it, would it not be to the advantage of Allied nations to receive all the goods that Germany could possibly send them?

The theory of free trade would at first blush appear to argue that the receipt of reparations and of Allied debts would prove a direct benefit to the nations concerned. If France, for example, should receive $10,000,000,000 of reparations, would not her wealth be increased by $10,000,000,000—"other things remaining equal"; and if the United States should receive the payment of European war debts, would she not be the wealthier by the amount of the payments—"other things being equal"? It is usually recognized in this line of argument that there would be some difficulties during the transition period—that the nations receiving the indemnities would have to shift their production to other lines of activity. But it is usually assumed that this shifting could be readily accomplished.

Although we do believe in the principles of free trade,

we cannot accept without serious qualifications this line of analysis as applied to the payment of huge reparations and international debts. The theory of free trade, as ordinarily expounded, is predicated upon assumptions of conditions that are fundamentally different from those which exist today. It presupposes the gradual evolution of trade and financial relations between nations; it presupposes relatively stable or "normal" conditions; and in its simplest form it usually presupposes that all nations are pursuing similar trade policies. The theory, however, recognizes difficulties in effecting a transition from a protectionist to a free trade régime; indeed, free traders usually admit that the passing over from protection to free trade should be compassed only gradually, in order that the attending disturbances to industry may be reduced to a minimum. Still, it is often urged that the difficulties of transition would ordinarily not be very great—that things would soon "automatically" adjust themselves to changed conditions.

Violent Trade Readjustment

This is no doubt true, ordinarily. But the present situation is not an ordinary one. The huge international obligations that have been incurred are not the result of gradual trade and financial evolution in the world at large, with industry and finance closely adjusted to each step in the process of growth and change. The Allied indebtedness is the result of a trade and financial readjustment and upheaval wholly unprecedented in history; the German indemnity reparation is the result of an ultimatum imposed by victor upon vanquished. The payment in full of Allied debts and of reparations—if it were possible—would accordingly force a readjustment of trade and industry in the nations receiving the goods of unprecedented severity.

It may be objected that the United States might receive

the payment of the principal of the Allied debts of some 14 billion dollars in very gradual instalments, and thus minimize the shock to industry. But the same objection cannot be made with reference to reparations. It is stipulated in the bond that Germany must begin payments at once and at the annual rate of $500,000,000 plus 26 per cent of the value of the total exports. It is important to bear in mind, moreover, that the interest alone on the Allied debts to the United States amounts to about $700,000,000 annually, and that if Europe were to cease further borrowing and merely commence the payment of interest, the United States would find itself with an adverse trade balance of about $700,000,000 annually.

Modern industry requires the investment of stupendous quantities of fixed capital. This is perhaps the most striking feature of the economic organization of the world today. The large-scale enterprises of the present are, moreover, commonly international in scope. For these reasons extensive readjustments of trade and industry produce consequences much more disastrous than was the case in former days. There is nothing "automatic" about a far-reaching reorganization of the modern industrial system.

The problem of international debts is put by John F. Dulles in the following graphic language:

"These vast debts could never have come into being under normal conditions. No more can they be fully paid under normal conditions. They can only be fully paid by economic efforts as violent and as destructive as those which were required to give them birth. A hurricane has swept over the world. We survey with grief the wreckage that lies in its train; but let us not commit the capital error of believing that all will be righted by another hurricane if only it blows from the opposite direction."

No one who realizes the enormous impetus that was given to American industry during the war as a result of

the huge foreign requirements for American goods that were superimposed upon the normal domestic and foreign demands, and no one who appreciates the depressing effects of the present changed conditions will deny that if Germany could succeed in making the reparations payments demanded, German industry would be greatly stimulated and Allied industry greatly depressed.

In this connection, it will be helpful to recall that war goods exported by the United States were not paid for; like reparations, they were gifts, so far at least as anyone can yet foresee. But none the less, Americans had their prosperity while the process was on. Indeed, it would seem that American contributions in the way of war materials and supplies cost us comparatively little as a nation. It was in considerable measure contributed out of the excess production that was stimulated by the war demands. There was steady employment at good wages for everyone. The industrial machine worked under high pressure, and until the latter months of the war at least, the total industrial output was very great. There is another side to all this, it is true. Prices were sky-rocketed; bank reserves were depleted; certain important industries were neglected; etc., etc. But while the game was on, the nation as a whole was extraordinarily prosperous.

Reparations and German Imports

It is sometimes urged that the expansion of German exports that would be required if Germany were to succeed in meeting her reparation obligations would not prove a detriment to Allied nations, for the reason that Germany would herself buy more from the Allies. Germany could not greatly expand her exports unless she first greatly increased her imports of raw materials, etc. Hence the Allied nations, it is urged, would gain as a result of enlarged sales to Germany.

There is undoubtedly an element of truth in this argument. Germany would, indeed, have to import heavily; and certain industries in certain countries would clearly profit in consequence. But this by no means warrants the conclusion that the Allies would reap a net benefit from the payments; it does not even disprove the contention that the net result would be detrimental to the Allies. For it must be remembered that if reparations are to be paid, it must be by an excess of exports over imports. Germany must not buy as much abroad as she sells abroad; she must import less by the precise amount of the reparations. Accordingly, Allied industry would find less ample markets than would be the case were no reparations made—with Germany free to use all of her exports as a means of buying imports. As free traders we insist that balanced trade between nations is desirable, and that unbalanced trade is practically certain to prove detrimental to the nations receiving the excess of imports.

French Indemnity of 1871

After the Franco-Prussian War Germany imposed an indemnity of $1,000,000,000 upon France. What light does the payment of this indemnity throw upon the present issue? The world has ever since marveled at the rapidity with which France effected the payments. Students of the question, however, have never reached agreement as to the precise effects and consequences of the operations involved. It was paid in part by a surrender of French securities in other countries. This portion of the payment, it will be seen, did not require an expansion of French exports. But the remainder—in the main—was paid with bills of exchange drawn against French exports. It is known that France enjoyed a period of prosperity during the interval, and that Germany was in the throes of depression. While other fac-

tors no doubt affected the situation, there is good reason to believe that the payment proved an industrial boomerang to Germany and that France felt the burden relatively little, largely meeting it out of stimulated business.

But, it will now be asked, if France could so quickly and so easily pay the indemnity of 1871, why cannot Germany now pay, as it is contended by so many that she can? The answer is that the Franco-Prussian War was a mere skirmish as compared with the World War. It lasted but a half-year; only two nations were involved; and it was in no sense a war of attrition. There was little disruption of world trade, or of the foreign exchanges, or of monetary and banking systems, or of the internal economic organization of the nations involved. Both France and Germany were, moreover, at that time essentially agricultural nations. Accordingly, the two situations are wholly different. For similar reasons, the economic recovery of Europe then was a very different problem from that of the present disordered times.

Illustrations of Economic Effects

It will help greatly to an understanding of the economic effects of the payment of reparations and Allied debts, if attention is given to some concrete cases. Under the terms of the Peace Treaty, in addition to surrendering the greater part of her mercantile fleet, Germany was required to build ships for the Allies at a certain rate per year. The Allies were satisfied with the arrangement so long as the post-war tonnage shortage prevailed. When the shipping depression developed, however, they were soon forced to cry quits, and to refuse further ships. So severe has been the depression in Allied shipping that the ships received by Great Britain are now being offered for sale at ruinous prices, with Germany almost the only purchaser. There is still under construction in German shipyards the *Bismarck,* the largest

and most magnificent ocean liner ever built. We are informed that it is to be delivered to the Red Star Line under a contract price with the government which it is already recognized will result in operating deficits.

An even more interesting case is that of coal. The Germans, with the ruthlessness which characterized all their war operations, wrecked the French coal fields when they evacuated France, hoping that by so doing they would make it for years impossible for the French and the Belgians to compete in supplying coal for the general European market. In fact, there is an official memorandum in which the German staff boasts of having secured this important advantage to German industry.

While Great Britain forthwith condemned this action of the Germans, events soon showed that it was of great advantage to the British coal industry. The huge continental demands for British coal in 1919-1920 enabled the British coal industry to thrive as never before. The government kept down the price of coal in Great Britain, with a view to stimulating domestic industry, while allowing the coal operators to charge on their foreign sales "all that the traffic would bear." The French in fact paid as high as 130 and the Italians 240 shillings a ton, the disparity being due largely to greater depreciation of Italian currency.

Meanwhile the Germans had been recalcitrant in delivering to France the coal stipulated under the Treaty of Versailles. By the terms of the Spa agreement, however, Germany was compelled to deliver 2 million tons of Ruhr coal per month. This supply exceeded French domestic requirements even before the business depression became severe, and by the fall of 1920 French railways and sidings were literally congested with coal trains. Coal prices fell precipitately—to 23 shillings per ton in France. In order to realize as much as possible the French government began

to sell excess coal to Holland, Scandinavia, and Italy for whatever price it would bring. In fact, it was sold at just about the cost of production in Germany.

England's market in France was gone and her shipments to other countries were greatly restricted. The low standard of living in German coal fields thus fixed the price of European coal. The coal strike in England, which for three months paralyzed all British industry, was the direct result of the necessity for British coal owners to compete with this indemnity coal. Although France profited somewhat by the receipt of German coal, the Spa deliveries were far from an unmixed benefit to the Allies in general.[1] To England they were almost a source of disaster.

There is something to be said, however, in favor of the shipments, for the very reason that they broke the incipient British coal monopoly on the continent. The prices of coal were so exorbitant that great damage was being done to industry everywhere. It is true, however, that in the end the collapse of coal prices would have come without the German competition. Coal could not long have escaped the liquidating process to which other industries were being subjected.

Export of Other Commodities

Other commodities with which Germany might hope to make large reparation payments are iron and steel, machinery, textiles, chemicals, and dyes. These commodities together with coal made up the bulk of German exports before the war. Which of them could be shipped into Allied countries without doing outright injury to Allied industry? Certainly not iron and steel, certainly not textiles, certainly not machinery. As a whole the Allied nations are more than

[1] It will be interesting to observe the attitude of France towards German coal deliveries when once the Lens fields have been reopened.

fully equipped to supply their own needs in all of these cases. Chemicals and dyestuffs the Allies wish to manufacture for military reasons. The simple truth is that every commodity with which Germany could most readily pay would seriously compete with Allied industries.

This sweeping statement needs some qualification, perhaps, for particular Allied nations might well be willing to receive certain of these commodities with a view to selling them in other Allied nations. The coal delivered to France is, of course, a case in point. It has recently been suggested, moreover, that France and Germany should work out together a plan whereby Germany can pay reparations to the benefit of France but to the detriment of the industries of England and the United States. A huge industrial combination is projected between French and German capitalists, whereby French ores and German coal might be united in the manufacture of low-priced iron and steel which could undersell British and American iron and steel even in their own markets. Whether anything will come of this scheme is very doubtful. It suggests, however, interesting possibilities of friction within the Entente.

Are there not other commodities, however, with which Germany can pay that will not disrupt Allied industries, either directly or indirectly? Undoubtedly there are some; and we hope the reader will bear in mind that the title of the preceding chapter is not "The Allies Are Unwilling to be Paid Anything," but only "How Much Are the Allies Willing to be Paid?" Certain materials for reconstruction, in limited quantities, may yet be accepted. It has been suggested, moreover, that many needed public school buildings might be erected in England if German materials were furnished free. Other commodities that have been mentioned are timber, potash, and sugar—these by the Right Hon. R. McKenna, chairman of the London Joint City and

Midland Bank, Ltd. He does not, however, think that much can be paid in this way. And the memorandum of the New Commerce prepared for the British National Committee of the International Chamber of Commerce (London, June, 1921) on the subject, "The Indemnity and Its Effects on Trade," says that "every commodity suggested will be found open to grave objection quite apart from possible mismanagement."

Payments by Small Consignments

One final suggestion remains to be considered. Recognizing the havoc that would be wrought upon certain Allied industries if Germany were to make the bulk of her payments in a few types of selected commodities, such as iron and steel, textiles, machinery, etc., some writers have advanced the doctrine that Germany should not pay the full amount through exporting great quantities of a few commodities, but rather by exporting small quantities of many commodities. The implication is that the Allies could receive small consignments of every type of German product without disrupting their own industries.

There are two important objections to this plausible suggestion. In the first place, if Germany is to be denied the opportunity to pay with those commodities that she can produce most efficiently and in the largest quantity, and is to be compelled to diversify her exports and to ship abroad only such precise quantities of each commodity as will not prove a detriment to Allied industries, the total amounts that she could pay would obviously be very greatly reduced. The administrative problems involved in such a procedure would, moreover, be of an impossible nature.

In the second place, those who argue that the Allies would find it beneficial to receive—in not too great quantities—many types of German goods, overlook the real

question. It would be nonsense to suppose that the Allied nations do not want any—indeed that they do not want many—German goods. But the real issue is whether they want German exports greatly to exceed German imports; whether they wish Germany to be able to buy from them as much as they wish to buy from Germany. We come back once more to the proposition that what is desirable is trade—balanced trade. If by requiring reparations payments we make it impossible for Germany to use exports as a means of purchasing imports, will not the loss of Allied markets in Germany more than offset any possible gains from reparations receipts?

Effect on the Foreign Exchanges

In preceding pages we have discussed the effects of the payment of reparations and Allied debts upon trade and industry. We have seen, however, that the payments are actually made mainly in bills of exchange. We may now consider what effects the payment of periodical instalments of reparations has upon the foreign exchanges.

Since the beginning of reparation payments under the terms of the Allied ultimatum, accepted by Germany on May 11, the exchanges have fluctuated more violently than ever. The graph on page 200 pictures the results of the reparation payments both on German and Allied exchanges. The trouble appears to be twofold. On the one hand, the necessity for Germany to acquire large amounts of acceptable exchange with which to meet reparation instalments periodically bulls the market for the exchange purchased. On the other hand, exchange speculators seek to take advantage of the situation and through their purchasing and selling activities greatly increase the range of fluctuations.

Under the terms of the May settlement it was first required that the reparations should be paid in American

exchange. The gyrations in the value of foreign currencies as compared with the American dollar that resulted led the Reparations Commission to modify this requirement with reference to subsequent payments and to require the remission of exchange on various countries. As the chart on page 200 indicates, however, the unsettling effects of the reparation payments upon the exchanges have not been overcome. The effects upon Allied exchanges, not to mention the effects upon the value of the mark, have been so disastrous that there has been serious official consideration of a postponement of further reparation payments for a year, in the vain hope that meanwhile some solution of the exchange aspect of the problem may be found.

The same exchange difficulties would be met if the Allied nations actually undertook the payment of their debts to the United States. Whenever large purchases of bills of exchange had to be made with which to meet instalments, foreign exchanges would fall in terms of American money. The door would meanwhile be left wide open for the violently disturbing effects of speculative activities. The fact that the exchanges might again rise after the instalments had been paid, does not change the fundamental difficulty. For, as we saw in the chapter devoted to a discussion of the foreign exchanges, the greatest evil in connection with the exchange situation lies in the rapid fluctuations of exchange rates.

Through this consideration of the effects of reparation and inter-Allied debt payments upon the exchanges, we again come back to the paramount question of the effects of reparation and debt payments upon the trade and industry of the Allied countries. Fluctuating exchanges are significant only in so far as they affect trade between countries. As we found in the chapter on the foreign exchanges, fluctuating exchange quotations mean greatly increased

risks of business operations, and hence a reduction in foreign trade. If the United States insists upon the payment of Allied debts to the United States, our foreign trade will be still further penalized through the unsettling effects of such payments upon the exchanges. If the Allied nations insist upon the payment of German reparations, they must take the consequences in the form of reduced exports to Germany and elsewhere.

Allied Debts and American Taxation

Uppermost in the mind of the average citizen is the thought that when European governments pay their debts to the United States, the burden of taxation in the United States will be greatly alleviated, just as the average Frenchman expects to find his taxation burden reduced when German reparations are paid. It may be recalled that of the $24,000,000,000 of our government debt, approximately $10,000,000,000 is represented by loans to Allied governments. The individuals who own Liberty bonds, however, have the promises to pay of the United States government; and in consequence, the government must pay interest on the Liberty bonds whether or not it receives interest on the foreign loans. Is it not true, therefore, that if the Allied nations were to pay interest on their debts to the United States, that the tax money which the government has to raise annually would be reduced by an amount equal to 5 per cent on $10,000,000,000, or $500,000,000? And is it not true that if the principal of the Allied debts is ultimately paid to the United States, we shall have received from abroad the means of liquidating $10,000,000,000 of debt which would otherwise have to come out of the pockets of the American people? Would not this consideration prove that it is advantageous to the United States to have the foreign obligations paid?

It is undoubtedly true that if the United States government received $500,000,000 annually as interest on the Allied debts, it would not have to raise that $500,000,000 from domestic taxpayers. At first blush it would therefore appear that the taxpayers having been saved $500,000,000, the nation would in consequence be $500,000,000 richer. This is, however, only a part of the story.

It will be remembered that foreign governments would have to secure the means of paying interest to the United States government through shipping to the United States more commodities than they purchased from the United States. Only by an excess of European exports to the United States, over European imports from the United States, can Europe secure a supply of bills of exchange which could be used in meeting these obligations to the United States. It must again be emphasized that if we compel Europe to use her present exports to pay past obligations, she cannot also use them in buying present and future American goods. Europe has been unable to buy much from us during the past year or so, even though we were not asking the payment of interest. Compel Europe to use her meager present purchasing power to settle past debts and our present exports would dwindle almost to zero.

Now if the losses resulting to our trade and industry from a great reduction in our exports and a great increase in our imports should amount to more than $500,000,000 annually, one would have to conclude that the nation as a whole would lose more than it gained. While the total of taxes would be reduced by $500,000,000, the total means of paying taxes would be reduced by more than $500,000,000. And if the principal were to be gradually paid over a long period of years, it would benefit the United States, only provided the total loss to the United States in consequence

of the industrial readjustments that would be involved did not exceed $10,000,000,000.

Loss from Trade Readjustment

It is, of course, impossible to compute with any degree of accuracy the extent to which our annual income would be reduced in consequence of the disrupting effects of huge debt payments. That it might annually well exceed the amount of interest, $500,000,000, plus principal instalments, is, however, not at all improbable. This for the reasons discussed in preceding pages of this chapter.

It will help to an understanding of this taxation aspect of the problem if it be recalled that during the period when the United States was shipping abroad the $10,000,000,000 worth of goods which gave rise to the debt, the funds raised by the United States government for the purpose of paying the exporters of the war supplies did not press heavily upon the American people. [2] Because of the huge profits arising out of war operations, American business men purchased large quantities of government bonds and paid large taxes without serious inconvenience. In 1919 and the early months of 1920, when huge additional credits were being extended, and when post-war exportations continued at the war-time level, the interest on the total government debt was met with relative ease, notwithstanding the exaggerated murmuring that emanated from certain quarters against the ruinous burden of taxation. We do not mean to imply that there was no burden, but only to contend that the fiscal problem was not particularly difficult so long as business prosperity was at its height. [3]

If the process is now reversed by the shipment of a great

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[2] It must be stated here, however, that a considerable percentage of the total came out of bank inflation rather than out of taxes.

[3] Recall the discussion on pages 224-225.

excess of goods to the United States, the resulting business depression might well make the burden of meeting the lessened total volume of taxes greater than that of meeting the larger volume under conditions where our industries were not compelled to undergo thorough and prolonged readjustment.

One further aspect of this problem should be noted. While the nation as a whole would probably not be benefited from a fiscal point of view, certain classes of people would find some alleviation of their tax burdens. People on fixed incomes, which are relatively little affected by business depression, would undoubtedly find that the payment of foreign debts to the United States government gave them taxation relief. But on the other hand, those who were thrown out of employment as a result of readjustment and depression would find the payment of such debts in the nature of a calamity. While their taxes would be reduced a little, their incomes would be very greatly reduced. The same would also be true of those whose incomes had been previously derived from profits in industries which would be disrupted in consequence of the trade readjustments. Even many bondholders who are in the fixed income class would suffer in consequence of the failure of certain lines of industry.

CHAPTER XVI

THE FRENCH-GERMAN RAPPROCHEMENT

New Agreement

Here and there in the preceding discussions of the reparations dilemma, reference has been made to the French-German rapprochement that has been worked out since the reparation settlement of May, 1921. This coming together in an agreement with reference to the delivery of German materials for reconstruction, has been widely heralded as a solution of the reparations problem. In the present chapter we shall outline the nature of the rapprochement in question and discuss its limitations.

We have found that from the time of the Armistice it has been assumed that Germany would pay in kind some of the reparations demanded. We have seen, moreover, that certain commodities have in limited quantities been already utilized for the purpose, such as coal, ships, livestock, rolling stock, etc. We have also noted that while in theory France has always been willing to receive German goods, yet when it actually came to agreeing to accept the designated commodities there has in most cases been first hesitation, and then refusal to receive the goods through fear of the effects upon French industries.[1]

A new agreement has, however, been worked out this summer between M. Loucheur, French Minister of the Devastated Regions, and Dr. Rathenau, German Minister of Reconstruction, whereby it is believed that Germany will now offer and France will now accept materials for the reconstruction of the devastated areas. While the full details of the plan

[1] See discussion on page 208.

have not, to our knowledge, been made public, we are informed that it is to be administered substantially as follows:

Persons in the devastated regions whose property has been destroyed during the war, or who have other claim for reparation, must first prove their claim to the French government. They then receive from the government an order for the amount required to rehabilitate the property destroyed. With this order they go to one of the several hundred financial agencies to be officially established in the devastated areas. There they find German and French officials who together examine these government orders; and in case the orders are satisfactory, a group of individuals desiring German materials is formed by the official agency and is put in direct communication with German manufacturers who produce the commodities desired. The price, date of delivery, etc., may be negotiated as in any ordinary private business transaction. In case of failure to reach an agreement with a German manufacturer, it is provided that a commission of three, composed of one Frenchman, one German, and a third person chosen by common accord, shall fix the terms. The price must correspond with the normal price in the interior of France for the material in question. The German manufacturer, upon the fulfilment of the contract, presents the order to the German government for reimbursement. The German government, in its turn, must of course raise the necessary funds either through taxation or through putting further pressure on the already overworked paper money printing press. The value of the transaction is then credited to the German government in the reparations account.

Payment in Goods

Under this agreement Germany is to deliver to France 7 billion gold marks worth of goods in the next five years,

provided this is compatible with the possibilities of production and the maintenance of the social and economic life of Germany. The agreement is also subject to German limitations as to supplies of raw material. The plan is conceived with a view of expediting the reparation of the devastated areas. During this period of five years the reparations payments made by Germany are to be limited to the 2 billion gold marks per year plus the payments in kind made to France under this agreement. The payment of 7 billions in goods to France is to take the place, during the five years, of the 26 per cent of German exports which it was agreed last spring should form the indeterminate part of Germany's reparation payments. That part of the 26 per cent, however, which remains unpaid by Germany after the deduction of the yearly payments under the Loucheur-Rathenau agreement although suspended for five years, will be paid by Germany to the Reparations Commission in yearly instalments beginning in 1926.

It will be seen that this Loucheur-Rathenau agreement increases the total of reparations which Germany engages herself to pay as compared with the amounts stipulated in the settlement made last spring. There is a further provision that only 35 per cent of the 7 billions of material is to be debited against France in the reparations account. In this way France expects to escape from owing large sums to the Reparations Commission. The difference between what is debited to France in the reparation account and what Germany actually pays in goods, that is to say, 65 per cent of the goods delivered by Germany during the five years, will be deducted from the payments which Germany is to make to France after 1926. It is with a view to budgetary relief that only 35 per cent of these payments in kind are to be deducted from France's share in the reparation account. The rest of the French claim for reparations dur-

ing these five years will supposedly be paid in cash and constitutes 52 per cent of the 2 billion gold marks in the reparation settlement of last spring.

In view of the added burden placed upon Germany, it is not surprising to find that Dr. Rathenau insisted on including the provisos mentioned above, namely, that Germany would engage to make these deliveries if it were compatible with the maintenance of her economic and social life, and if her supplies of raw materials and her productive capacity permitted. In the light of our analysis in Chapter XIII of Germany's capacity to pay, there need be no expectation that France will receive the materials in the volume contemplated.

It will, moreover, be seen that to the extent that Germany devotes her economic resources to the supplying of these materials for reconstruction, it reduces her possibilities of exporting other goods with which to secure the bills of exchange required to meet the other two-thirds of the French share. There is thus a possibility that France may receive a smaller amount of funds for wiping out accumulated deficits than might otherwise have been the case; while the chance of receiving pension money, etc., is likewise rendered more remote. The delivery of such materials would, however, afford some relief to future French budgets, since the French government would not henceforth have to defray the expenses of reconstruction, except in so far as the labor involved is concerned.

This agreement between France and Germany may also seriously affect the amount of reparations that Italy, Belgium, and Great Britain might otherwise hope to receive. The total reparation figures, as we have hitherto seen, are fantastic; Germany cannot pay anything approaching the sums demanded. To the degree, therefore, that she specializes on making deliveries to France, she reduces the possible

payments to the other Allies. If the plan works out in this fashion, there will be an excellent opportunity for dissension among the recipients. Indeed, Britain has already protested.

Legislative Action Necessary

This agreement for the delivery of materials appears to disprove, to some extent at least, our contentions in preceding chapters, that France is unwilling to receive German goods in payment of reparations. To understand the forces that have led to this apparent willingness of France to receive German materials for reconstruction, it is necessary to reveal certain conflicting interests within France. The French budgetary situation has been growing steadily worse; and the large annual deficits are in considerable measure attributable to the policy whereby the French government has advanced the funds required for the reconstruction of the devastated areas. Government experts, French financiers, and those who are suffering most from the burden of taxation, actual and potential, have become deeply concerned. They feel that the present method of effecting the restoration of the devastated regions cannot be allowed to go on. France must get the materials from Germany free of charge and restore the devastated areas as rapidly as possible, to the end that the budget may not be further burdened and that French productive capacity may be quickly restored.

We have seen that this view has all along had considerable weight in France; but it has heretofore not been able to outweigh the counter-views of French industrialists, desirous of furnishing the materials required and reaping the profits to be obtained from government contracts. These interests, it may be taken for granted, are still opposed to the destructive competition of free German materials. Whether they will be able to bring sufficient pressure to bear to

prevent the operation of the plan remains to be seen. It must be understood that the plan has yet to receive the sanction of the French Chamber and Senate. Thus far it is merely an agreement between ministers. In the parliamentary discussions still to come one may be certain that the forces of opposition will be strongly organized.

Limitations of the Scheme

Whatever the eventual outcome of the plan, it remains to be noted that it does not in any event reach to the heart of the reparations question. From the point of view of France, the following limitations must be observed:

1. It will not provide money to pay for the labor involved in the restoration of the devastated areas.

2. It will not pay for either the labor or the materials that have been required in reconstruction work during the past two years. It will, therefore, not give any positive relief to the French budget, burdened by the huge expenditures already made on reconstruction. It will not reimburse the French for what they themselves have already accomplished. In this connection it is important to note that the French contend that a very considerable part of the work of reconstruction has already been completed.

3. It will not provide money for either past or future pensions; and pensions amount to something like 40 per cent of the total French reparation claims.

4. The plan does not cover the entire period during which it is expected that Germany will make reparation payments. The agreement is to last only five years, by which time it is hoped that the devastated areas will have been fully restored.[2] After that the question arises, will France be willing to receive other types of commodities in like amounts?

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[2] Recall, however, that one-half of these deliveries are to be debited against France on the next five years' instalments.

The plan, moreover, provides no means whatever for paying Great Britain and the other Allies. The French share of the total reparations is 52 per cent. Sixty-five per cent of the French share and all of the 49 per cent due the other Allies must still be paid, if paid at all, in funds arising out of an excess of ordinary German exports over imports. It works out, therefore, that during the first ten years only about one-sixth of the total is to be received in materials. After that this agreement makes no provision for any payments in kind.

In spite of this widely proclaimed solution of the problem, the fundamental reparations dilemma still exists, namely, the concurrent insistence that Germany must pay in full and the refusal on the part of the Allies to receive, save in limited quantities, the goods with which alone it is possible for reparations to be paid.

CHAPTER XVII

POLITICAL FACTORS IN THE EUROPEAN SITUATION

Political Backwardness of Nations

This book so far has considered the economic decadence of the world and has endeavored to show that this economic deterioration threatens a serious decline in civilization. Aside from the economic factors involved, there are certain powerful political forces at work which are preventing a co-operative and rational effort toward European rehabilitation. These will be discussed in this and the following chapter.

There can be little doubt that the political development of Europe has not kept pace with the economic development. The economic interdependence of nations which has been developing in the last forty years in connection with the growth of large-scale production and highly specialized industry, has found its chief impediment in the stagnation of the political ideals governing each nation. Politically, nations are in general about where they were before the development of modern industrialism made them so closely interdependent. Each one is dominated by an individualistic nationalist policy, finding its support in antiquated doctrines which have among the masses almost the power of religious beliefs. For example, the United States, now hopelessly entangled in the meshes of European economics and politics, still harks back to the doctrine of splendid isolation of the days of Washington. Each nation politically opposes international co-operation and may be said to be working against its own larger interests, since in fact these interests are

interlocked with the interests of every other nation. Therefore, the political life of each nation is running counter not only to the trend of world development, but is also standing in the way of its own participation in that development.

This view may seem almost treasonable to national political policies, of venerable age and embedded in the very souls of nations through centuries of political and military strife. But it cannot be too often repeated that the world today has changed; it has become indissolubly bound together in the processes of earning its daily bread, and these processes are the ones which affect the life and well-being of the masses of every nation. So long as politics ignores these processes in directing the policy of nations, so long must politics remain in antagonism to the fundamental requirements of mankind.

We do not mean to imply that through international co-operation trade competition between nations can or should be eliminated. We do mean to contend, however, that unless national political policies permit the unrestricted exchange of commodities between nations and the restoration of world trade and industry, there is little hope—as indicated in Chapter XI on the unity of the problem—for a restoration of economic and political security, and for some measure of progress for the masses of mankind. Concretely, the postwar tendencies towards governmental support of trading combinations and monopolies, seeking by treaty and intrigue special and exclusive national privileges throughout the world, must give way to equal trading opportunities as between the individuals of different nations. Concretely, also, the tariff and trade barriers erected by the new nations of central and eastern Europe, by the old nations of central and western Europe, and by the great republic of the West, [1]

[1] This question will be further treated in the third part of the book.

must not be permitted to stand in the way of the restoration of the world's trade and commerce.

Clash of Political and Economic Interests

The war, by impoverishing nations and upsetting commerce and industry has accentuated the opposition between national political aims and world economic needs. Great masses of the population whose very existence had been made possible by the development of economic internationalism, are now at the mercy of destructive political policies opposed to international co-operation. War, the backbone of political reaction, has killed any movement for international co-operation that had begun to grow before 1914. For this reason the League of Nations was so organized as largely to defeat its own purpose.

The war and the peace have left a heritage of hatred, vengeance, and distrust among the nations of Europe, which has saddled upon statesmen a resulting habit of concealment, misrepresentation, and distortion. How otherwise could ministers keep in office and work out a plan of reconstruction when every issue had been falsified in the public consciousness by the dogma of hate? Even at the beginning of the Peace Conference delegates stated that they could not discuss openly European settlements. This could only mean that they could not give to the public the real reasons for decisions reached. We do not contend that this situation could have been otherwise; we only wish to call attention to actual conditions and to their effects.

The people of Europe, fed on untruthful and misleading propaganda, deliberately intended during the war to fan their passions into flame, were in no frame of mind after the war either to view the problems of peace through reason, or to give unbiased consideration to facts which would stand the test of honest research. For this reason one cannot

find the real purposes of governments in the conflicting published statements of political leaders. They must largely be sought in the exigencies of domestic politics.

Hoodwinking the Public

There have always been two strata of policy behind every political action of governments in Europe. One stratum, founded on old political dogmas, whose utility has long since departed, was fabricated for public consumption and delicately suited to its palate. The other stratum, based upon actual facts, is for the information of foreign offices only; it varies to a greater or lesser degree with the policies publicly announced. It is for this reason that representatives of the United States government, who first went to Europe after the war, were astonished at the cynicism of public men in the countries they visited.

This divergence between the public and the private views of political leaders in Europe did not produce before the war such disastrous effects as now threaten in the crumbling of the economic and social structure of Europe. The war, like an earthquake, brought a complete separation between the two strata of political life. In the end parliamentary government depends on public opinion, and the great problem now is how to bring about reconstruction in accordance with reason and reality when public passion is still seething in the overheated furnace of nationalism, and when public opinion formed in the twisted and misshapen mold of war has ceased to carry its load in the political structure. Public opinion today rests so largely on supposititious data, far removed from reality, that it has become a factor of danger rather than of safety to the State.

It is true that, owing to the curb of uneducated and shifting public opinion, leadership in a democracy has always labored under the disadvantage that it could not

carry through a consistent single-minded, and therefore effective, plan of action. In pre-war times, however, democracy overcame its handicap of lesser efficiency by assuring greater opportunity and wider freedom to the masses of people. Today the need and danger of the civilized world is so great that this curb of popular opinion, changed to a lash of fury by the passions and the propaganda born of war, threatens to drive statesmanship into far-reaching disaster.

The situation is further endangered by the inability of statesmen, under the sway of their own political oratory, to discern the true significance of the complicated forces with which they are dealing. Leadership in European democracy threatens again to fall into the hands of "The Four Horsemen of the Apocalypse"—Conquest, War, Famine, and Death. From this dread quadrumvirate only statesmanship which, like Lincoln's, is fearless of political death, can rescue civilization.

Situation Realized by Statesmen

It is not to be supposed that at this late date Allied statesmen are altogether ignorant either of the gravity of the European economic situation or of the dilemma of reparations. As we have previously indicated, the utter confusion of mind that prevailed at the time of the Armistice has in large measure been dissipated by contact during the last two years with the practical problems of reparations administration. Premiers Lloyd George and Briand, at least, knew last winter, at the very time the ultimatum of Paris was drawn, that the Allied nations themselves were unwilling to receive from Germany the payments demanded under the threat of further military occupation. The following quotations constitute the proof of this assertion—the first being from Lloyd George:

"What I have put forward is an expression of the views of all the experts . . . Everyone wants gold, which Germany has not got; and they will not take German goods. Nations can only pay debts by gold, goods, services, or bills of exchange on nations which are its debtors.

"The real difficulty . . . is due to the difficulty of securing payment outside the limits of Germany. Germany could pay—pay easily—inside her own boundary, but she could not export her forests, railways, or land across her own frontiers and make them over to the Allies. Take the railways, for example. Suppose the Allies took possession of them and doubled the charges; they would be paid in paper marks which would be valueless directly they crossed the frontier.

"The only way Germany could pay was by way of exports—that is, by difference between German imports and exports. If, however, German imports were too much restricted, the Germans would be unable to obtain food and raw materials necessary for their manufacturers. Some of Germany's principal markets—Russia and central Europe—were no longer purchasers, and if she exported too much to the Allies, it meant the ruin of their industry and lack of employment for their people. Even in the case of neutrals, it was only possible generally to increase German exports by depriving our traders of their markets." [2]

The second is from Premier Briand, made before the French Chamber and Senate on February 3, 1921:

"We must not lose sight of the fact that in order to pay us Germany must every year create wealth abroad for herself by developing her exports and reducing her imports to strictly necessary things. She can only do that to the detriment of the commerce and industry of the Allies. That is

[2] *The London Times,* January 28, 1921.

a strange and regrettable consequence of facts. The placing of an annuity on her exports, payable in foreign values, will, however, correct as much as possible this paradoxical situation."

Contradictory Statements

In some respects this statement of the French Premier is an amazing one. While admitting that the Allies are unwilling to permit Germany to increase her exports for fear of the consequences upon Allied industries, he adds that the annuity on German exports, which in this Paris settlement was 12 per cent, will solve the dilemma "as much as possible." Now the truth is that this 12 per cent tax provision merely added an indeterminate amount to the total reparations that Germany would have to pay; and the 12 per cent portion, along with the rest, would have to be paid by the exportation of German goods.

Reading between the lines, one may perhaps infer that Premier Briand thought that the 12 per cent tax might reduce German exports, and thus prevent the disastrous effects of German competition upon Allied industries. If so, one is desirous of knowing how Germany is to pay when Briand himself admits that an excess of exports over imports constitutes the only means of payment. Or, perhaps, what one finds between the lines is a deliberate intention to obscure and confuse the issues.

The statement is also interesting in view of the fact that the Allies are just as unwilling to permit the German government to restrict imports, as to permit an expansion of German exports. The reader will recall in this connection the discussion of the German attempt to prevent the importation of luxuries through the "hole in the west," and its nullification by the Allies. [3]

[3] See page 193.

It is also interesting, not to say enlightening, to contrast the statement of Lloyd George given above with his ultimatum pronouncement, a few weeks later, in March, when he said:

"We have simply insisted that Germany pay the reparations which she owes . . . We have not asked more. We cannot ask less." "Unless we learn by Monday next that Germany is ready to execute the demands of Paris . . . The Allies are agreed to the following decisions." [4]

German Attitude

Allied statesmen were not alone in avoiding the real issue in the settlement. They found substantial help from the Germans in escaping official confession of the real dilemma and the consequent wrath of their own people whom they had led to expect far more than could possibly be realized. It appears that the haze which befogged Allied statesmen also obscured the vision of the Germans, who might have utilized the dilemma to their own advantage. The German government, however, took every occasion to obstruct the work of the Reparations Commission. The proposals made by them in London were on their face inacceptable to the Allies, and in the words of Lloyd George constituted a repudiation of settlements made at Versailles. Simons, the German Minister of Foreign Affairs was accused by Lloyd George of declaring in public speeches that Germany was not responsible for the war. It is difficult to explain the dilatory and vexatious tactics of the Germans when an open statement of the issue would have brought to the light of day the real difficulty, and would have materially assisted in placing Germany in a tenable and favorable position before the

[4] Conference of London, March 3, 1921, Answer of Allies to Germany by David Lloyd George. For details of the measures to be taken, see page 217.

world. It is one of the wonders of modern times that German statesmen did not say to the Allies, in the words of Norman Angell: [5]

"It is common ground that we can only pay in commodities. If you will indicate the kind and quantity of goods we shall deliver, and will facilitate the import into Germany of, and the payment for, the necessary food and raw material, we will accept—on that condition—even your figures of reparation."

It may be possible, however, that the Germans feared to make the issue clear before the people of the Entente nations. If in the post-war psychology of peoples it were really understood that only a small portion of reparations could be extracted from Germany, would there not have been a cry in France for a different kind of payment? Would not popular opinion have demanded outright a permanent cession of Rhineland, and perhaps even of the Ruhr coal fields? "If Germany cannot pay in money or goods, let her settle the bill by territory."

Mystery of Motives Actuating Statesmen

What is the explanation of the contradictory statements of Allied statesmen? What were their real purposes? In the thickly carpeted inner offices of Downing Street and the Quai d'Orsay, where perfect quiet reigns and no turmoil reaches them from the outside world, what thoughts were directing M. Briand and Mr. Lloyd George? Whispering officials hourly lay upon their desks reports gathered minutely through a network of secret channels, covering the conditions of Europe, and the efforts of bankrupt governments to re-establish their countries.

Beyond the thought of that speech to be delivered to-

[5] Norman Angell, "The Fruits of Victory," page 324.

morrow, with which they must satisfy their turbulent constituents, did either of them contemplate the possibility of additional changes in the map of Europe which would further disrupt the economic system and consequently take the power to earn their daily bread from great masses of population? What plan formed itself in the minds of these masters of the destiny of millions of people in central and eastern Europe? What motives of policy reaching into the future were there which they did not, could not, dared not, tell to their clamoring parliaments—real motives which would decide their action? Did they fear the divergent interests of Britain and France, and therefore plan to obscure the reparations issue? For, if it became clear that Germany could not pay, would not the swelling tide of public wrath give power to that party in France which desired German disintegration? Did they not conceal their dilemma from the public through fear that the political events in each of their countries would strain the Entente to the breaking point? And are they not juggling with the reparation problem in order to give public opinion time to subside and reach something like "normalcy"?

It is extremely difficult to analyze the political motives of those who are now directing the destinies of Europe. And even if this could be done, it would not be safe to draw therefrom definite conclusions about the future. At best politics is not an exact science. In the ever-changing kaleidoscope of present world events, shifting public opinion, and the rise and fall of parties through Machiavellian combinations, screened from the public eye, form the rapidly moving film of the national political drama. Men, motives, plans, appear in the calcium glare only to disappear into the void. What is true today vanishes, before we grasp it, into the mists of yesterday. All that can be attempted is to estimate the trend of national political

movements, and, in the large, the direction in which these movements are tending. Any attempt to formulate international policy—and every nation must have its international policy—must be based upon the best interpretation it is possible to make.

Public Sentiment

Undoubtedly, the confusion which had prevailed from the beginning concerning the exigencies of reparations payments was gradually clearing in the minds of European statesmen with the concrete development of the problem. But if they had come to understand more clearly the reparations dilemma, Lloyd George and Briand were not on that account much nearer its solution. They both were faced (more especially Briand) with a resolute opposition which was ready to take every advantage of each concession existing governments might make to reach a real solution of reparations. Behind the opposition was the general public determination that Germany should be made to pay. For this state of public sentiment the French and British governments were in a large measure responsible. Just prior to the Peace Conference, M. Klotz, the French Minister of Finance under Clemenceau, had declared uncompromisingly in favor of making Germany pay the whole cost of the war. Lloyd George had scarcely been more discreet. Soon after the Armistice the elections took place in Great Britain. There was need of a campaign cry. In spite of a hard and fast agreement between Allied executives and the German government that the measure of German payments was to be merely the damage done by German acts of war to the civilian population, the campaign cry that Germany should be made to pay the whole cost of the war, to the uttermost farthing, was adopted by the Lloyd George government. The great mass of the people confronted with heavy taxa-

tion was therefore given direct promises that they should be relieved of this burden through the supposedly simple process of compelling Germany to disgorge.

In the Peace Conference, as we have already seen in the chapter on the history of reparations, the Reparations Commission (the President of which was M. Klotz) found that of necessity the reparations would have to be confined to the direct damage wrought by Germany during the war, plus pensions. The idea of compelling Germany to pay the full cost of the war was abandoned as impossible. Thus the Treaty pared down a portion of the promises made by the French and British governments to their constituents. This was followed in each country by steadily mounting taxation, continuing budget deficits, and pyramiding debts, which gave the opposition the strongest grounds on which to attack the government for non-fulfilment of promised reparations payments.

Political Alignment in France

We have been speaking of the opposition to the French official policy of adapting demands to German conditions. What groups, what interests, compose this opposition? First, there is the great mass of people who, because of misleading propaganda, perennially blow hot and cold on the subject of reparations. They want Germany to pay in full, in order to relieve French taxation burdens and provide pension money; but at the same time they wish to see Germany rendered impotent as a military industrial power, to the end that future peace and security may be vouchsafed to France. So long as the truth about reparations is not made clear to these people, they alternately hope and fear that Germany will prove her capacity to pay. They do not see the payment-in-goods dilemma; but they realize that a paying, and therefore a prosperous Germany would prove a future

menace to France; hence their fear. Now the moment it appears that Germany cannot, or will not pay, or that the Allies themselves will not permit Germany to pay, these people, if left in the dark, will thenceforth blow only hot, and demand the crippling of Germany.

Secondly, there is a group which bases its policy on old traditions of military diplomacy. It comprises the military party and the royalists, who hark back to the halcyon days of French supremacy in Europe under the kings. It also includes the chauvinists in all parties and certain powerful business interests. To this political bloc, which believes that little is to be gotten out of Germany because of her traditional bad faith, the reparations issue has been only a means to an end. They use this issue as a means of bringing on a crisis in which they can secure the support of the masses for destroying the Treaty of Versailles, which in their opinion establishes a status leading inevitably to German revenge. They will give their support to any policy which may prevent the recovery of German industrial and military power.

French Chauvinists

There is little doubt that M. Briand is no partisan of further French military adventures in Germany. But the recalcitrancy of Germany, combined with the failure of the Reparations Commission to hand over any cash to lighten the French budget situation, certainly strengthened the hands of the chauvinist party desiring the ultimate dismemberment of Germany. The German refusal to accept the Paris proposals of the Allies, or even to suggest a plan that would seem to give satisfaction to the Allied demands, seemed to force the Premier's hand to a drastic plan of action. M. Briand had to give leadership to French public opinion, which cried out for something to be done to bring the recalcitrant Germans to terms.

In an interview with American correspondents, M. Briand gave as the reason for France's proposed occupation of the Ruhr, the military protection of France. "Germany has not disarmed according to the terms of the Treaty. The Franco-German frontier is only a thin line, which our experts consider insecure."

This statement does not agree with the public declaration of the Allied Disarmament Commission, which in 1920 stated that the present armament of Germany was not a danger to France, but rather increased the danger of disturbances in Germany. The statement also ignores the military occupation of Rhineland with bridgeheads on the Rhine, which occupation, by the terms of the Treaty, will last at least fifteen years. France does not rely, therefore, on her "thin frontier line" as a military protection.

M. Briand is also quoted as saying: "The occupation of this territory will also prove advantageous from a financial viewpoint. It will also give us the center of the German manufacturing district, as well as the heart of the munitions industry."

There could be no financial advantage in the temporary occupation of the Ruhr; on the contrary, as Briand has himself at other times admitted, it would only increase the French fiscal burden. Even the possession of the heart of the munitions industry could have a military value only if such occupation were made permanent. The Premier here appears to be giving support to the militarist party; but in the light of other expressed views, one may doubt whether M. Briand has any intention of following this suggestion to its logical conclusion.

Uncertain Tenure of French Premiers

Political parties in France are as shifting as the people are versatile. Originally a Socialist, M. Briand now belongs

to no party. He has himself jokingly stated that he is a renegade of all parties. He has in recent years, however, been moving steadily towards the right. There are many parties in the Chamber of Deputies, from the left with the Socialists, through the center with the Radical Socialists (the latter being far from radical and not by any means socialistic), to the Clericals on the right. It cannot be said that there is any distinct alignment of parties on the questions involved in reparations and German dismemberment; but in a general way the extreme right has been in favor of the most drastic action against Germany, while the left has favored closer relations with Germany and leniency in the execution of Treaty terms. Briand holds his power, as do nearly all French premiers, through political trading among the different parties. Permanency, however, is uncertain, and, holding office through such combinations, the Cabinet may be swept aside by any wave of popular opinion which reinforces the opposition.

It is difficult for Americans, with only two great parties and without the European parliamentary form of government, to imagine how uncertain and fragile that tenor of office is which requires the support of many factions and combinations of parties and individuals. European premiers have to possess extreme political sagacity and capacity to turn and twist in the parliamentary game in order to obtain and hold power. For this reason under the temper of the masses today the premiers are more noted for their eloquence and agility than for far-seeing statesmanship. Such was the uncertain condition of the French Cabinet when the crisis of last spring occurred.

It is very generally thought that the threat then made to seize the Ruhr and the actual occupation of the Rhine ports were only measures to call the German bluff and bring Germany to her senses concerning her reparations obliga-

tions. As a matter of fact this explanation is only a superficial one. The agitation to occupy the Ruhr, of which for the time being Briand was the mouthpiece (apparently a somewhat unwilling mouthpiece), represents a political movement of a fundamental character in European politics. It is a movement, moreover, which did not exhaust itself in the French threat to occupy the Ruhr last spring. It is likely to reappear again in more or less the same way whenever Germany fails to meet payments or to fulfil the terms of the Treaty of Versailles.

American Withdrawal

What, then, is this situation which the mass of the French people believe confronts them on the continent of Europe? What are the political forces at work in which the French have seen the jeopardy of their own safety in the near and in the far future? A study of the French political outlook is important for the light it throws upon the whole European problem, and because there is much in this point of view which is justified by historical experience and by the present trend of political events.

In the first place, there has always been the all-important question of America's attitude in European affairs. During the political campaign of 1920 the position of the Republican party was so ambiguous that France was naturally at sea as to the attitude of the American government in the probable event of a change in administration. President Harding's inaugural address was therefore awaited with eager interest. It may be recalled that it came at the very time of the London conference on reparations, at the end of which the ultimatum was served upon Germany.

It may not be without significance, moreover, that the policy developed by the Allies for the further occupation of German territory in May last, when the German govern-

ment refused to accept the ultimatum, was adopted shortly after the British ambassador to the United States had returned to Europe. He must have carried with him the information that the United States would probably not become a party with Great Britain to the Treaty guaranteeing France against future German aggression in accordance with the agreement reached at the time of the Peace Conference. He must also have informed the Allied governments that the United States would probably neither become a member of the League of Nations, nor actively join in enforcing the Treaty of Versailles. In general the British ambassador must have convinced the Allies that the United States government had no intention of entering entangling alliances abroad, or of participating in the balance of power which might re-establish itself in Europe. Such information undoubtedly shifted the attention of M. Briand and the French people from the economic problems which confronted France to the no less distressing political and military situation which promised to develop on the European continent.

Without the active support of the United States in the European situation, France could not but view with misgiving the probable future political alignments in Europe. The disruption of Austria-Hungary into small incapable states, divided internally and hostile to one another, afforded an unusual opportunity for re-established Germany to acquire control over "Mittel-Europa." France feels that German capacity for organization would undoubtedly establish within a generation predominant economic and political influence in all central Europe.

France and Slav Nations

Secondly, there is little doubt that the French, relying on historic tradition, had placed great hopes on the newly

formed Polish state. As time passed, however, she began to view with alarm the weakness of Poland and the probability that it would take a long term of years to establish there a stable self-dependent state and ally. The territorial delimitations of the country made certain the hostility of Russia and Germany to Poland and almost assured an alliance between Germany and Russia. Ever since the revolution, Russia and the Russians had become more and more alienated from France and had shown a decided tendency to turn for support to Germany. The attitude of Great Britain in the occupation of Constantinople, in the recognition of the independence of the Baltic provinces, and in her assent to the occupation of Vladivostok by the Japanese, had aroused the antagonism of Pan-Slavism in Jugoslavia and Czechoslovakia, to say nothing of the anti-British feeling among the intelligensia of inchoate Russia. The old Slav grievance had been revived. Great Britain was preventing the Slavs from reaching outlets to the sea. It was not impossible that the antagonism to Great Britain of Pan-Slavism in a re-established Russia might be extended to France as an ally of Great Britain. This was especially true, since France could no longer afford the luxury of buying Russian support by great loans. If Germany were to recover her economic stability and consequently her political power, the future offered indeed a dark outlook. The problem was intensified by the evident difficulty, which increased as time went on, of preventing Austria from joining Germany, and thereby increasing the population and power of the traditional enemy.

There were additional reasons why France must view the future with distrust if Germany should recover her economic and consequently her political power. Italy, ever since the Armistice, had shown marked leanings towards Germany; and it was an open secret that only Germany's

present weakness still conserved Italy as a member of the Entente. The dismemberment of Austria-Hungary had removed the barrier which before the war prevented a genuinely friendly alliance between Italy and Germany. France certainly could not risk the possibility of an alliance between Germany and Italy, and perhaps the stronger nations of the Balkans, as well as an alliance between Germany and a rejuvenated Russia. She could not face the possibility of a future war against such a combination with only Great Britain as a certain ally.

The French Impasse

On the other hand, if France should ultimately decide to throw in her lot with the Slavs, she might drive Great Britain and Germany together in a formidable combination, particularly if Italy, Bulgaria, and Hungary should be added to the combination. The political future for France was at best shrouded in mystery, owing to the chaos in Russia. Would that great country come back as a unit and take her place in the old council of nations, or would she divide into more or less hostile states which would further complicate the balance of power? Safety evidently lay in keeping Germany down, at least until the political atmosphere had cleared.

America alone could furnish a guarantee to France against future German aggression. But America now refused to enter an alliance with England and France to guarantee the latter against a possible German attack. This refusal seemed full of sinister portent to the French. In Europe military alliances are regarded as the very breath of political life, almost a necessity of national existence. Therefore, our refusal to join such an alliance with our former friends and companions in arms must have indicated to the French that they could no longer count on us. They

could not understand friendship on the basis of splendid isolation. The dislike of military alliances seemed to them only a kind of pretence. Military aid in the hour of need was from the French point of view the only basis of friendship.

Even if Russia did not recover for half a century, indications were plentiful enough that Germany with her business organization would absorb the markets—such as they were—of the descendent countries of Austria-Hungary. Already Germany had a practical monopoly of Polish exports in 1920, as shown by the report of the Polish government. This could only mean the strengthening of Germany and her ability to resist the permanent enforcement of the Treaty of Versailles, and the consequent growing danger, as each decade passed, of German revenge. In the event of a new war, France could no longer count on Russia to stem the tide of a German onslaught, as in the Muscovite counter-attack in East Prussia when the battle of the Marne was raging. Even if Russia remained in chaos, France, with her lesser population and her weak allies in the East, could not resist the power of a re-established Germany.

As the negotiations following the peace brought more and more to the foreground the divergence of the political aims of France and Great Britain, the peril of the immediate future seemed imminent. Could France count permanently on the British alliance? It even appeared as if in time she must choose between her friendship with the southern Slavs and her entente with Britain. The divergence of aims between Britain and France was becoming each day more evident. British economic interests were clamoring for the markets of a re-established Germany, while political France was seeking safety in political and economic readjustments in middle Europe. Such readjustments would mean permanently weakened and impoverished countries.

Policy of Dismembering Germany

In the national peril that was thus foreshadowed, it is not surprising that there should be in the consciousness of every Frenchman the ever recurring thought that German recovery must be prevented, that Germany must be reduced to a position where she will be forever powerless to attack France. This result could be accomplished in two ways: the one, territorial; the other, economic. If Germany were divided into several states, whose political interest were sufficiently divergent, France would be safe. Or, on the other hand, by taking from Germany her iron and coal deposits, France would strip the iron gauntlet from the Teutonic fist and render the German nation forever impotent.

Such plans were not new to French statesmanship. From the beginning of the war, articles and pamphlets were published in France advocating the dismemberment of the German Empire. In 1917—shortly before the Russian Revolution—notes were exchanged between the Russian and French governments. These notes constituted an embryo agreement, whereby France was to allow Russia to draw her own frontiers on the west, that is to say, to annex the whole of Poland and, if so desired, the coal fields of upper Silesia. On the other hand, Russia agreed that France, besides recovering Alsace-Lorraine and annexing the Saar Basin, should be allowed to establish an independent buffer state in Rhineland on the west bank of the Rhine. French public men have consistently called attention to the fact that whenever in history Germany has been divided into small states, these states have quarreled among themselves and left France unmolested. It is frequently stated in France that the division of Germany into a south German state, Catholic and reactionary, and a north German state, Protestant and radical, would assure France of that much needed rest and

security which would enable her to disband her armies and apply all her strength to economic rehabilitation.

In the words of a leading French editorial writer, who is considered an interpreter of the views of a section of the French foreign office and of the royalist party: "In the past it has only been when Germany has been divided into small states that she has left France alone. The Treaty of Versailles is the worst possible, since it ultimately exposes France to German attack. The sooner we come to a break with Germany on the execution of that treaty, the better. And let it come before Germany has recovered too much."

Separatist Issue

In pursuance of this policy, the French administration in the Rhenish area of occupation encouraged the separatist movement among the German people. This movement for an independent Rhenish state showed some indications of success during the Peace Conference, and might have been carried through, had it not been for the strenuous opposition of the American and British governments. Quite contrary to diplomatic precedent, France also sent a French minister to the Bavarian government, with a view to stimulating the separatist movement between north and south Germany. But here again, France was met by British and American opposition. There was, however, another element more potent than the opposition of her two allies, which interfered with the desire of France to see Germany divided into separate states. Four years of terrible war and the bitter terms of the Treaty of Versailles had consolidated further the German people, and there now seemed little hope of procuring a lasting division, which found no support in the heart or desire of the masses.

This separatist issue, in fact, came up in connection with the enforcement of the terms of the Treaty of Versailles.

Germany was to reduce her army to 100,000 men. During the year 1920, while the army and armament were reduced to a point where the head of the French Disarmament Commission said that Germany had ceased to be a military danger to France, still she had not yet literally complied with the disarmament terms of the Treaty of Versailles. Spurred on by the disorders incident to the radical revolution in Bavaria, the Bavarians formed among the bourgeois class a home defense guard intended to protect them against the possibility of future radical upheaval. The Allies, declaring that this home guard was really intended to keep alive the German military organization, insisted on the literal fulfilment of the disarmament clauses of the Treaty of Versailles. They unwaveringly demanded the disarmament of the home protection guard; and they finally compelled the Berlin central government to take radical action directed against the Bavarian government to secure this disarmament. For a period the issue seemed to threaten a rupture between the north and south of Germany. Bavarian public men declared that they would secede from north Germany rather than disarm. This crisis, however, soon passed, and when the real test came, the Bavarian Prime Minister stated publicly that the unity of Germany was paramount and that Bavarians should not offer open resistance to agents of the Berlin government, who had come to Bavaria to oversee the disarmament of the home defense guard.

French Economic Policy Toward Germany

Thus the hope of France of bringing about a division of Germany subsided. It did not die, however, for the French realize full well that there is a fundamental spiritual antagonism between north and south Germany. There is hope, therefore, that this antagonism may be stimulated sufficiently to bring results some day. For the moment, however,

French reactionary opinion turned to the other alternative. It was thought that if Germany were deprived of the coal of the Ruhr Valley through seizure as a forfeiture for the non-payment of reparations, and if Poland succeeded in securing a permanent allotment of the mines of upper Silesia, the fangs of industrial and military Germany would be drawn. It should be understood, however, that there was not a united opinion in France in favor of this alternative.

This plan would put in French hands the power to dole out to German industries such amounts of coal and iron as might seem expedient. It would place the very means of existence for the German industrial class in the hands of the French government. In this way, it was thought, France could at any time curb German economic prosperity, should it recover sufficiently to become a menace. She could even compel the German population to starve or emigrate.

Only two years ago the Allied and Associated Powers induced their enemies to disarm under an Armistice agreement that would render them powerless to resist invasion. This end was attained by some very definite promises made by the executives of Allied and Associated Powers to these enemies. The breach of these promises in the treaties afterwards drawn and in the post-war action of the Allies constitute a very definite factor in the psychology of conquerors and conquered alike, which may prove the controlling force in the political life of Europe for many years to come. It is this international bad faith which since the Treaty of Peace is compelling France to take radical steps to prevent Germany from seeking revenge.

French Distrust

This aggressive French policy is a logical deduction from certain fundamental tenets of the French faith. First,

not the slightest faith is placed in the possibility of a future friendly and pacific Germany. Second, the French place little trust in the League of Nations as an effective agency of international peace. Third, they believe they cannot count upon American aid in the event of a new German attack. Fourth, they are not sure of the British alliance, they profoundly distrust the Italians, and no other effective alliance seems possible. Granted these premises, the only logical policy for France to pursue appears to be to keep Germany down, now that she has her down. The question, of course, remains whether the premises are altogether sound. It may also be questioned whether in view of the world economic and political situation France can single-handed pursue such a policy.

At the present moment popular opinion in France has experienced a wave of reaction. The agreement of Germany to fulfil the Allied reparation demands of May, and particularly the agreement to furnish 7 billions of materials in five years for the reconstruction of the devastated areas, has produced a very favorable impression on the masses in France. "Germany is endeavoring to pay." What will be the next reaction, when it appears that the effort is beyond German strength, cannot be foretold. Neither can it be estimated whether the pressure which France and the other Allies will exert on Germany may go to the breaking point before the peoples of Allied countries realize what has happened. Whether it be the breakdown of Germany's fiscal system, accompanied by stoppage of factories, a stupendous business crisis, and political and social upheaval, or the equally disastrous episode of a further military occupation of the Ruhr, makes little difference. The effects would be manifested in the United States, as well as in every country of Europe. There is, however, hope in the fact that a broader sentiment of co-operation now appears

to be rising in France. This spirit finds much reinforcement in the attitude of Great Britain, and will, it is to be hoped, find support in the United States.

It would seem, however, that a strong counterforce against this spirit of co-operation is the French attitude on armaments. We know that the French government will oppose reducing her present army on the ground that the European situation will not allow it. Her military men, whose prestige grew enormously during the war, are likely to hold the whip hand in this matter. France naturally sees in her dominant army the only certain security in the face of the multitude of political possibilities that threaten her national existence. If the worst comes to the worst, she will have in that army—now the only real army in Europe,—the power with which to meet any emergency. At least this is what the people believe.

There is, however, a counter and powerful feeling in the nation that, whatever betide, France cannot afford to isolate herself from her allies. Whenever diplomatic negotiation reaches a point where the dissolution of the Entente seems imminent, and France faces the possibility of standing alone in the continental maelstrom, sober second thought has, to the present moment, always tempered the national policy. And in the future the attitude of Great Britain and America will undoubtedly continue to have great weight in the councils of the French Republic.

CHAPTER XVIII

POLITICAL FACTORS IN THE EUROPEAN SITUATION (CONTINUED)

Great Britain and France After the War

The heritage of war and the dread of bolshevism in Europe gave to Great Britain, after the Armistice, a conservative government. The position of this government, composed as it was of a coalition of many divergent elements which inherently tended to pull apart, was anything but secure. The leaders saw opposed to them the increasing power of the Labor party which grew each month in radicalism. Among the members of the Coalition party one not infrequently heard the statement that only the political legerdemain of Lloyd George saved Britain from a Labor government. Indeed, it was for this reason that the conservatists accepted the leadership of this former liberal, whom they inherently disliked and distrusted. There was no agrarian population of small landowners on whom they could count for conservative support. Neither could the imperialist group in the government rely on the adherence of the British middle class, which, overburdened with taxation, cried out against the growing expense of government.

In order to conciliate labor, the Coalition government increased and extended unemployment insurance; but this added to the burden of taxation. It was to be expected, therefore, that the Coalition government should in turn seek to conciliate the taxpayer by joining France in demanding payment from Germany to the last sou and the last farthing. This policy naturally found a ready response in the British middle class; for Great Britain was endeavoring to carry

the load of war through taxation and the burden was proving almost more than she could bear. It is not surprising, therefore, that British taxpayers gave undivided support to a government which promised some measure of relief through German reparations.

There was another reason why the conservative government of Great Britain was inclined to follow France in her continental policy. France had not attempted to load the whole burden of war on the shoulders of her taxpayers. Consequently, the conservative Chamber of Deputies, elected after the war, found powerful support among the conservative peasants and the equally contented bourgeoisie; for both these classes were receiving from the government full interest on the great war loans. In addition, the government was expending huge sums in the devastated areas, thereby stimulating business. The peasants and the bourgeoisie in their rôle as taxpayers were not, however, called upon to defray more than half of these government expenditures. France was therefore a relatively stable and well-balanced country, in no way endangered by radical labor upheavals or by experiments in social and economic reorganization. Her influence was one which the conservatives of Britain felt they must support in order that the situation on the continent should furnish a good example to the British people of stable government and conservative action. Safety lay in sticking close to France and reinforcing the alliance.

Parting of the Ways

This British policy was evident in the action of the government throughout the inflation period of 1919-1920. But when in the fall of 1920 and in the winter of 1921 the world business depression began to close British factories, a new tendency developed in British public opinion. There came a partial realization by

the common-sense business mind of Britain, that the world-wide business collapse made economic considerations paramount. International markets on which British industries depended had disappeared. Central Europe had been the best of these markets. Before the war British exporters had always complained of hated German competition in world commerce; but now it was becoming more and more evident that if German industry had harassed British trade in some quarters, it had nevertheless produced in Germany a vast power of consumption which absorbed huge quantities of British manufactured goods. What Britain lost in other markets through German competition she more than made up by selling goods direct to prosperous Germany.[1] The war had not only destroyed this market, but it had also eliminated the markets of the other countries of central and eastern Europe. This, however, was not all; the markets of South America, China, and Japan had succumbed to the world-wide business depression. These circumstances forced home the realization of the interdependence of international trade. The only thing that would save the industries of Britain—and save Britain—was the re-establishment of international trade. For this purpose some measure of rehabilitation was necessary in Germany, which, after Great Britain, was the great director and stimulator of world commerce.

Thus slowly but surely Britain and France were coming to the parting of the ways. To France the pre-eminent consideration was the danger of German revenge. Britain would perhaps go far to help collect reparations, for she still vaguely expected to get some fiscal relief from this source; but she would not join in using the reparations issue to further German disintegration, nor would she support

[1] See also page 142.

any policy which had for its aim the dismemberment of the German Empire, and therefore, the complete breakdown of the European industrial system. Nevertheless, it was not the desire of the British government to come to the breaking point with France. The weakened condition of her empire would not permit of such a policy, and there was still a strong feeling in Britain that the Allies ought to stand together.

Threatened Occupation of the Ruhr Basin

In the spring of 1921 the uncompromising resistance of the Germans to the reparation demands of the Allies, reinforced by the general confusion which prevailed concerning what kind of reparation payments were possible, seemed to make it imperative for Great Britain and France to stand undivided in forcing from Germany a recognition of her debt to the Allies. It was for this reason that Lloyd George himself signed the Allied ultimatum of March. It is noteworthy that by so doing Great Britain was able to modify France's plan for further German occupation. The French government at that time undoubtedly had determined to extend Allied military occupation over the Ruhr coal and industrial regions.

To understand the significance of this proposed action one must realize that the so-called basin of the Ruhr comprises a territory about thirty miles long and twenty miles broad. Over the breadth and width of this area stretches an almost continuous city of factories and mines. It is undoubtedly the most intensively developed manufacturing and mining district in the world. It is well called the heart of German industry and German economic life.

Leading German business financiers and bankers assert, and we see no reason to doubt this assertion, that the occupation of the Ruhr by a foreign military force, with all

the inhibitions and prohibitions that such military occupation implies, would practically stop the flow of German industrial life.

Some of these financiers, among the most powerful in Germany, have gone so far as to assert that in case such an occupation occurs they will cast their lot with Bolshevik Russia. Whether this declaration is an idle threat cannot now be determined, and it is immaterial to this discussion. The important consideration is that people of various nationalities who have been studying the German situation at close quarters affirm that the occupation of the Ruhr could precipitate a political and economic crisis in Germany which might well lead in the north to social upheaval and in the south to secession.

Undoubtedly in the mind of the British government the military occupation of the Ruhr was not to be thought of. As a compromise, Britain consented to co-operate with France in taking military possession of the ports of Düsseldorf, Duisburg, and Ruhrort on the right bank of the Rhine. Thus by co-operating with France, Britain sought to restrain the latter's militarist tendencies.

British Anti-Slav Policy

However fraught with danger the disagreement of the economic policy of Britain with the French military policy may be, there is another important principle of British foreign policy which has led to even more serious disagreement between the French and British governments over the settlement of German problems. This tenet, held by the British foreign office and exemplified by the attitude of Great Britain towards Poland on the question of the corridor to the sea and the free city of Danzig, finds more recent expression in the French-British disagreement over the plebiscite decision in upper Silesia. While upper Silesia is

of secondary industrial importance to the Ruhr, nevertheless by means of the industrial organization of upper Silesia Germany has dominated business and commercial development throughout the rest of central and eastern Europe. For Great Britain, therefore, it was important, if Germany was to resume her function as business director and organizer of central and eastern Europe, that upper Silesia should be conserved to her practically intact.

As we have seen, however, the French were of another mind. They wished to make of Poland a great and powerful state, that could stand as a buffer between Germany and Russia. In such a state the coal fields and resulting industries of upper Silesia would play an important part. France, therefore, threw the whole weight of her influence into the balance to obtain for Poland a major part of the mines of upper Silesia. It is said that in the quarrel that ensued, the French obtained an agreement from the Poles by which French interests would control 60 per cent of the coal fields and industries which Poland might acquire. On the other hand, rumor has it that the British have an agreement with the Germans of upper Silesia that Britain on her part should control 60 per cent of the industries which remained in German possession. Whatever truth there may be in these reports, there is revealed in the conflict over upper Silesia a fundamental antagonism of purpose between France and Great Britain.

If France looks on Germany as a hereditary foe and sees in the Slav a protection against Teutonic onslaught, Britain takes quite the opposite view. The Slav is to the British mind the greatest danger to the British Empire. Since before the days of the Crimea, Britain has consistently opposed Slav expansion. She has feared the Slav pressure through Persia and Afghanistan to India; she has feared and opposed the Slav expansion to Constantinople and the

Mediterranean as a threat against the Suez Canal and her dominion in Egypt. More recently she has feared the Slav proximity to her newly acquired dominions in Mesopotamia and Persia. There is a measure of truth in the Slav belief that Britain is keeping Russia off the seas. Whereas France considers German militarism the fundamental threat to European civilization, Britain regards this danger as now partly submerged in the greater danger of the Slav awakening. To her there looms now more ominously than in the past, threatening her empire in the future, the danger of "the Slav avalanche."

Fear of a Greater Russia

This anxiety over Slav expansion is best exemplified in the present attitude of Great Britain at Constantinople. There the British realize that they can no longer afford the luxury of a permanent military occupation. Since the war they have tried in various ways to secure some effective buffer to stand between the possessions of the British Empire and the Slav. At first they tried to induce the United States to take over the administration and control of Constantinople and the surrounding district. Next they endeavored to induce the Italians to assume a protectorship over the peoples of the Caucasus. They distrusted the French in this situation because of the Pan-Slavic sympathies of France. Despairing of inducing any great power to assume the responsibility of acting as a buffer between Great Britain and Pan-Slavia, British statesmanship turned to Greece and endeavored to stimulate the Greek ambition for the re-establishment of ancient Greek Byzantium. The aim is to create a new and powerful Greece along the eastern Mediterranean as a check to Slav expansion southward.

In the Baltic States, Britain is the one great power which has recognized the independence of Esthonia, Litvia, and

Lithuania. These states were a part of Greater Russia, but inhabited in the main by distinct nationalities, who, when the revolution came, demanded their independence. All the Slavs say that Great Britain by the recognition and aid given these states has been endeavoring to prevent the re-establishment of Greater Russia and to destroy Russian influence in the Baltic. Thus it will be seen that Great Britain is in a measure assuming the German point of view, that the great menace to Europe, as well as to the British Empire, is the Slav.

In spite of the fact that Russia has always been a thinly populated country, Russian governments since the days of Catherine and Peter the Great have extended Muscovite tentacles towards the absorption of further territory. Russia has always reached out toward Persia, toward Turkish Asia, and toward Constantinople. Russian policy has been to organize the southern Slavs in the Balkans, and its great ambition before the war was to disintegrate the dual empire of Austria-Hungary and consolidate its Slavic populations into a federation, closely affiliated with the Russian state.

In spite of the present chaos in Russia, Great Britain notes with alarm the realization of the independence and the union of the southern Slavs. She sees, with the re-establishment of Russia, an all-powerful Pan-Slavic movement pushing southward and westward, a greater menace to the peace of western Europe, and more especially of the British Empire, than were the Germans themselves in the fullness of their military power.

This British fear of Russia has all along been accentuated by the unprecedented increase of Slavic population as compared with those of other nations, and their tendency to spread and infiltrate across the frontiers of the nations to the west. Like Bismarck, the British fear nothing so

much as the fecundity of the Slav woman. Therefore, Britain does not desire to see Germany, the great opponent of Pan-Slavia, divided and crushed so that she will offer little resistance to the westward movement of Slavic peoples.

It may be added in this connection that Italy will be found by the side of Great Britain. Before the war Italy feared the Austrian Empire. Today she fears nothing so much as the encroachment of the Slav. Already the southern Slavs threaten to crowd Italy from the eastern shores of the Adriatic, and the Italian realizes, as well as does the Britisher, that the great barrier to the Slav is the Teuton.

British Military Policy

Behind the British desire for re-established commerce and markets, which leads her to oppose the French efforts to divide Germany, and behind the British endeavor to stem the tide of Slav expansion, there is still another and deeper founded tenet of British national policy. Great Britain is close to the continent of Europe. Her food supply, the raw material for her factories, indeed her very existence as a nation and as an empire, demand from a military point of view the control of the high seas. She cannot, therefore, afford to see any nation predominant in Europe, or any combination of nations, that might threaten her naval supremacy.

We have seen that the British policy toward Germany since the war, has been largely determined by economic considerations, and that this policy is in harmony with opposition to the Slav menace. On the other hand, British policy in the Baltic and in the Levant is very far removed from such plans of action as would coincide with her economic needs. It is undoubtedly true that Britain cannot in her present condition afford the expense of the continued military occupation of Constantinople and Mesopotamia.

Furthermore, she is in no position to re-establish the ancient power of Byzantine Greece. In addition, she will find it far beyond her means to support the independence of the Baltic provinces against the active interference of Poland and Russia. It must be remembered that the political policy intended to hold back a united Slav development is, in itself, a means of turning slumbering Slav antipathy into bitter hatred. Such hatred may in the future cost Great Britain dearly.

Britain is therefore governed by considerations of military politics only to a less degree than France. Let us consider some recent political events in Europe to discover, if possible, how these policies of France and Great Britain are working out, and whether they promise a reasonable degree of success to each of these nations and promote tranquillity and reconstruction on the continent of Europe as a whole.

French and British Clash in Turkey

Two developments since the war will suffice for our purpose. We have seen that the British policy requires a buffer state at Constantinople and along the eastern Mediterranean to protect its African and western Asiatic empire, and preserve from danger that channel of circulation in the body of the empire, the Suez Canal. For this purpose she has selected Greece. Her plans for the aggrandizement of Greece, however, not only stir the hatred of the Slavs, but also bring her in direct conflict with her ally, France. For France, if she can prevent it, will not allow Britain to hand over Constantinople to the Greeks, because the Greek government of King Constantine represents the anti-French movement in the Levant. France wants a Turkey with sufficient resources to pay the French owners of the Ottoman debt. France believes that if any power has a right to in-

herit Constantinople from Turkey it is a re-established Russia, to whom Constantinople was promised during the war. Thus the British policy in Constantinople is approaching a checkmate. It has alienated France and is embittering potential Slavic enemies.

But the most immediate and regrettable results of this policy are evidenced in the continuing chaos in the Levant. In the present Greco-Turkish War, Great Britain is supporting Greece with money and arms, while France is known to be furnishing both arms and officers to the Turks. There is authority for the statement that among the Turkish troops captured by the Greeks in Asia Minor were French officers.

A further effect of the British and French clash in Turkey and the Balkans is the marked and continued economic deterioration of the whole Levant. The war between the Greeks and the Turks threatens to become perennial, and to prolong indefinitely the cessation of commerce with the interior of Asia Minor. Constantinople itself is in a pitiable plight. The city is overflowing with refugees—Russians, Armenians, and Greeks. It is in imminent danger now of an attack by the Turks, and again from occupation by the Greeks. Food is scarce and bad, and its cost all but prohibitive. The filth everywhere is beyond description. Even that former luxurious continental hotel on the Bosporus, the Para Palace, is rendered almost uninhabitable by dirt and vermin. If an American commerical traveler wishes to go from Paris to Constantinople and return, he will have to pay simply for visés on his passport, $160. He must secure French, British, Swiss, Austrian, Bulgarian, Serbian, Italian, and Greek visés, both going and coming, and in obtaining them he will everywhere meet with the hostile and dilatory tactics of government officials, such as always exist in situations where every traveler is prima facie under suspicion. All of these conditions indicate, and in turn

cause, discouragement of trade and industry, and continued economic decay.

Failure of French Pro-Slav Policy

The French military-political policy has not been more successful than has the British. The shifting political and economic trend in each country, on which France seeks to rely, has at critical moments proved out of tune with the French policy. For instance, France counted on the iron ring of states around Germany to keep the latter bottled up. She thought that for this purpose she had cemented sufficiently friendly relation with Poland, Czechoslovakia, and Roumania.

A part of this policy of strengthening the iron ring about Germany was the plan to unseat in Russia the Bolshevik regime, which France believed friendly to Germany, and to substitute a government friendly to herself, thus assuring a Pan-Slav movement sympathetic with France and hostile to Germany. Failing to accomplish this end herself, France in turn gave support to Kolchak, Denikin, and Wrangle; in fact, to all the numerous adventurers who promised opposition to bolshevism. Finally her military agents urged Poland to wage an offensive against the Bolsheviks. When the Poles went beyond the advice of these agents in their disastrous expedition to Kiev, France, seeing the Bolsheviks threatening at the gates of Warsaw, had to come to the active military support of Poland. She called for aid from Czechoslovakia and Roumania. Her political policy counted on these two countries to support her; but to her chagrin she found that neither of them would undertake an anti-bolshevik campaign. Czechoslovakia had a Socialist government whose last desire was to attack the Bolshevists, or to support the Poles whom they hated. The Roumanians, in spite of the aid France had given in reorganizing their

armies during the war, had too much trouble in keeping control of the territory they had acquired during the war to think of attacking anyone—except Hungary, in case opportunity offered and others would join her. The dissatisfaction in Bessarabia made it most impolitic for Roumania to make war on the Bolshevik government, and thus invite the loss of her newly acquired province. The only power that offered to come to the aid of France was Hungary, but Czechoslovakia would not allow Hungarian troops to cross her territory. Thus French military diplomacy broke down at its very inception.

For the moment it is true, Jugoslavia, with its monarchic government, may support French policies, but no one can tell how long that support is likely to last. The Pan-Slav movement in that country and the deplorable economic conditions under which the Serbs are living, have stirred among them a strong and growing sympathy for Bolshevik Russia. So serious is this Serbian movement that the Serbian king refused for a time to return to Belgrade. One might multiply instances of the failures of the ancient military diplomacy in post-war Europe; but the cases cited are sufficient for present purposes.

Suggested Balances of Power

We have seen in the preceding pages some of the effects of the British and French military diplomatic policy in the current situation in Europe, and the influence which these policies are having on the economic situation. It cannot be said that these policies have yielded desirable results to the nations concerned, or assisted in a rehabilitation that would promise some measure of peace and prosperity to Europe. Let us now look forward. Is there any probability that the military policies of France and Great Britain, the only powers now in a position to act internationally, will yield

any better results in the future? For this purpose it will be necessary to consider what national alliances in a new European balance of power are foreshadowed in Europe today. Although in the very uncertain post-war political situation, few have ventured to predict what the future balance of power will be; nevertheless the considerations of future political alignments are of preponderant influence on the present policies of all European governments. Two possible balances of power have been suggested by students of the situation.

The first and the one most believed in France is an alliance between Germany and Russia, and that whether Russia remains bolshevik or not. To this alliance would be gathered Italy, reconciled to Austria and even to Jugoslavia. France, therefore, could hope for an alliance only with Hungary, Bulgaria, Roumania, and Poland. Such political affiliations would, of course, be no military balance of power at all, without Great Britain in the French alliance. Even with Great Britain in the alliance, the probable result of a military struggle, if we may judge from the events of the Great War, would be the hopeless collapse of the French, British, Polish, Bulgarian, Roumanian group. It must be remembered that Britain cannot at one and the same time keep up a big army and maintain her supremacy of the seas.

On the other hand, a student of the political situation suggests the following balance of power: Russia is to become reconciled to Poland and allied to France. She will secure the support of Czechoslovakia and Jugoslavia. In the other scale of the international balance would be Germany allied to Italy, Austria, Hungary, Bulgaria, and Roumania. Great Britain and the United States would remain isolated. This combination would be a real balance, in which the superior organizing power of the Germans would be offset by the greater population of the Slavic states.

The hatred of Poland for Russia is, however, as great as that of France for Germany, and it is founded on more prolonged suffering than that of France. It is difficult, therefore, to conceive a balance of power in Europe founded on a reconciliation of Poland and Russia. For that matter, the first hypothesis—an alliance of Germany, Russia, Czechoslovakia, Jugoslavia, Italy, and Austria—implies a reconciliation between Italy and the Slavs, and between Germany and the Czechs, both of which events seem equally improbable.

Real Balance of Power Improbable in Near Future

We find in recent international developments in Europe little indication that either of these suggested alliances is taking shape, or that any other balance of power is in the making. Some of the leading manifestations of future international relationships in Europe are deserving of attention. The most striking illustration is the perpetual disagreement among the Allies over the execution of the peace treaties. The hostility of Italy to France [2] and the divergence of interest between France and Great Britain are evident enough. Accompanying the threatened dissolution of the Entente is an incipient rapprochement between Italy and Germany. In central Europe the Little Entente—Czechoslovakia, Jugoslavia, and Roumania—is the first real alliance made since the war. It is aimed to prevent Hungary from receiving the territory taken from her by the war settlements. It is at once apparent that the re-entry of a rehabilitated Russia into the arena of military politics in Europe would upset this alliance. A Russia

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[2] The hostility between Italy and France has reached such a point that recently a French mission on peaceful errand of paying reverence to those French soldiers who were killed on the Italian front were mobbed in Italian cities.

governed by military diplomacy would seek at once the recovery of Bessarabia from Roumania. Both Jugoslavia and Czechoslovakia would doubtless seek close ties with Russia, and certainly would give no support to Roumania against Russia. The hostility of Russia and Poland, and the equally great enmity between Germany and Poland, constitute permanent political tendencies bred in the bone of these nations. The hatred of Germany and France is, of course, also a permanent factor that must be reckoned with, not to mention the increasing antagonism of the Slavs to Great Britain.

These forces, which are those now most apparent in Europe, give no inkling as to the probable balance of power which will in the end evolve. The truth is that the most likely outcome of the present political chaos in Europe is that there will be for many years to come no real military balance of power.

Three Nations Eliminated

The practical bankruptcy of every European government will shortly affect its international political policy. Italy is already feeling the pressure of the world economic crisis to such a degree that the Italian government has been obliged to abandon its military adventures in Albania and Asia Minor. Italian imperialism has, in large measure, been given up, at least for some years to come. And the Italians say that it is better for them at present not to mix too ardently in European political entanglements, since they have all they can attend to in re-establishing their own country, without meddling in outside matters which cost much and under present conditions are fraught with extreme danger.

For a generation Germany cannot be counted upon as an important factor in any new balance of power.

Germany must go through bankruptcy in the not distant future, and that painful process is likely to absorb all her energies. Russia is equally out of the game. Her recovery must of necessity be slow. The once greater Russia is a unit only in name. Time may bring a permanent division into separate states, or a confederation may ultimately evolve. But in the meantime Russia's regrowth to something like her former power will be a slow process, involving a constantly changing value as an ally for other powers. For instance, France is today seeking to upset the Soviet government in order to secure a Russia which will be favorable to a French alliance. Yet, on the other hand, most other European governments, as well as the Russian exiles, now desire the continuance of the Soviet government for the present because they feel that that government is now the only force that can conceivably prevent complete economic and social chaos in that most unhappy of lands.

With Italy, Germany, and Russia out of any military international alignment, it is obvious that no real European balance of great powers is possible for some time to come. Meanwhile, if militarism is to prevail instead of the politics of economics, each nation will struggle to maintain large armed forces in order to protect itself against military uncertainty as well as to attain a fitting position when the future balance of power is finally evolved. If a military imperialist policy prevails in Europe in spite of the poverty of nations, internal troubles, and general decadence, and if the United States maintains her aloofness, it is not at all improbable that another European war, or several European wars, will be necessary for the re-establishment of the balance of power, for the reason that the peace has left the military power in the hands of a small minority on the continent.

Present Examples of Disagreement

The points of conflict between French and British policies show themselves in continual disagreements, of which the following are today examples:

1. The French have made a treaty with the Turkish nationalist government under Mustafha Kemel Pasha. This treaty conflicts with British policy in the Levant, which desires Greek supremacy.
2. In the Serbian-Albanian conflict, France sides with Serbia and Great Britain with Albania: neither of them on grounds of justice and equity but from divergent nationalistic interest. France inclines to back the Pan-Slav movement in the Balkans, while Great Britain fears it.
3. The British have protested against the Loucheur-Rathenau agreement, whereby Germany is to pay France reparations in goods.
4. Finally, Great Britain now favors giving Germany a moratorium on reparation payments for two years. This proposal angers the French to bitterness.

Coming Predominance of Economic Considerations

Such, then, is the confused status of European politics in general. Since the Armistice there has been nothing but drifting in the counter currents of military and economic needs. There is, moreover, nowhere discernible among leading nations any united policy designed to facilitate the restoration of the shattered economic and social organization. For example, the political policies of France and Great Britain are based on fundamentally contradictory beliefs, or fears, which prevent a concerted policy of reconstruction. And the worst of it is that they are based on

bugbears of the past. The British fear of the Slav and the French fear of the Teuton were conceived, born, and matured when Russia and Germany were puissant nations and not the impotent remnants of today. Either the French or the British policy may lead nations to further destructive conflicts, but neither can furnish the basis for the industrial reconstruction of Europe.

What are the real factors that will direct the course of developments in Europe in the next few years—for good or for evil? As we have stated in the previous chapter, the controlling forces will be those which concern themselves with the needs of great masses of people for their daily bread. More and more the present situation will demonstrate that without closer international co-operation these masses cannot secure the minimum requirements for subsistence. Slowly but surely economic considerations will reveal the folly of political policies formulated by elderly statesmen who are still looking over their shoulders for the guide-posts of a departed era.

Already in Great Britain we find that, owing to the burden of taxation and the grave industrial crisis, there is a broader realization of the economic interdependence of the world and of the consequent need for international co-operation. In Great Britain there is a growing and ever greater pressure to eliminate military expeditions and military occupations. Under the pressure of the taxpayer, Parliament is ever demanding greater economy of the government. Military diplomacy would lead Great Britain to make her occupation of Constantinople a permanent one; but today the British acknowledge that they cannot afford to continue that occupation, and the government, in its financial distress, is, as we have seen, urging on the Greeks in their war against the Turks, in the hope that the former may control Constantinople and Asia Minor. But the Greek government

itself is in no position to maintain its authority against the Turks by force of arms; and if it strains its financial resources in an endeavor to do so, it will ultimately meet with serious domestic difficulties.

Likelihood of Ruhr Occupation

In France, on the other hand, where the burden of war costs has not been shouldered by the taxpayers, it is not yet fully realized that the resources with which to carry out a policy of European control do not exist. Accordingly, the paramount political issue in Europe today is, What will France do when Germany defaults on her reparations obligation? Will she rush forward into new military adventures by the occupation of the Ruhr coal and industrial region, or will she be governed by more prudent counsel? A multitude of possible contingencies make prophecy hazardous. The outcome depends not only on economic considerations, but also on the psychology of masses and leaders. Public opinion changes rapidly; new governments arise to substitute new policies. However, the important forces which appear on the political horizon to influence the French decision in the matter of occupying the Ruhr, are as follows:

When Germany defaults, French public opinion will be divided into two camps. On the one hand, there will be a demand for some action to compel payment. If Germany cannot, or will not, pay in specie or in commodities, then she must pay in territory. The opposition to the government, backed by powerful groups on the right and center of the Chamber of Deputies, will therefore demand drastic military action, involving the occupation of the Ruhr and the Westphalian industrial region. That the representatives of other nations who have been in touch with the developments of the reparations problem believe this situation is bound to arise, is proved by the fact that some of them, who desire

a pacific solution of the reparations problem, have unofficially endeavored to induce the Allied evacuation of Düsseldorf, Ruhrort, and Duisburg. The idea is that when Germany defaults on reparations the Allies could again occupy these cities, and thus do something to quiet popular clamor.

The demand of the militarist group in France for the occupation of the Ruhr will not be dictated primarily by the hope of securing reparations. If Germany does not pay—if France cannot regain her economic strength through the receipt of German reparations—then the only alternative this group sees is the permanent crippling of Germany as a military industrial power. That this demand will meet with much popular support is apparent from the analysis of the French political situation made in the preceding chapter. There is in the background of almost every Frenchman's mind the fear of German recovery and German revenge.

On the other hand, there will be a large body of French popular opinion opposed to further military action by France, because of the realization that such action would involve the country in vast military expenditures and at the same time would offer no immediate prospect of securing reparations and little prospect of ultimate economic gain.

What relative political strength these divergent points of view will have it is impossible at the moment to foreshadow. Frank H. Simonds, the well-known military and political critic, who is conceded to be close to the French foreign office, has stated unqualifiedly that if Germany fails to pay, France will seize the Ruhr, *volens nolens.* [3] No one can be wholly certain of this, however, because of the shifting currents of public opinion that prevail. If the truth about

[3] "Germany Takes Her Medicine," *American Review of Reviews*, June, 1921.

reparations dawns slowly on the French people, through a process of education, the chances of avoiding military action will of course be greatly enhanced. But if the crisis comes suddenly, with public opinion unprepared, it is probable that the demand for military occupation will be so great that whatever the inclination of the existing government, it would be compelled to occupy the Ruhr, or give place to a government that would.

Other Factors

There is one other factor which may affect the decision of the French government on the occupation of the Ruhr. Our view of the desperate financial condition of France is now shared by a large body of Frenchmen. Indeed, there is a social and political group forming, whose sole purpose is to be ready to take a hand whenever the present fiscal policy leads to political upheaval and perhaps social revolution. In such a crisis this new organization, which has groups in every important city in France, proposes when revolution comes to intervene by force and prevent, if possible, wholesale destruction of property. One of the leaders of this movement says: "Revolutionists don't make revolutions; it is the bourgeoisie, when they are really aroused, who do it. Talk of the proletariat; but watch these little shopkeepers when the government stops paying interest on their government bond holdings. Then is when we'll have real revolution." In view of the hopeless condition of French government finances, it is not impossible that sooner or later the French government will be brought face to face with the possibility of a serious social upheaval. In such a contingency might not the occupation of the Ruhr, by directing public anger against Germany, provide the necessary safety-valve for the French government?

There is a possibility, however, that outside influences

will profoundly affect the French decision. Premier Briand himself has announced in the Chamber of Deputies—and his announcement received the supporting vote of that body—that France cannot afford to isolate herself from her former allies and go it alone. Although there are powerful individuals and groups in Great Britain who favor drastic measures against Germany in case she fails to pay reparations, still it may be predicted that the British government, with the support of the majority of Parliament, will oppose the military occupation of the Ruhr.

How great a weight such British opposition will have with France at such a moment is difficult to estimate. Much will depend on how far other political and economic issues and settlements have strained the alliance between Britain and France. Again much may depend on the operation of the Loucheur-Rathenau agreement for the delivery of German goods for the rehabilitation of the devastated areas. Should this agreement be ratified in the Chamber of Deputies, and should it affect adversely French industry, a corresponding anti-German feeling might thereby be aroused in France. When the moment of the final decision arrives, it seems probable that the weight of American influence may turn the scales.

Economic Consequences of Occupation

It may prove interesting to inquire what might happen if, in the event of German default, France should elect to seize and control the Westphalian industrial district. There are those who believe that France would thus be able to collect reparations, notwithstanding the failure to do so through the occupation of the Rhine cities. There are those, however, who suggest that instead of endeavoring to collect reparations through seizing German customs and other revenues, France should take control of certain Ger-

man key industries and utilize them so as to secure reparation payments. This has been suggested by numerous Frenchmen, and even by a well-known editor in the United States, whose publication has broad influence on American public opinion. In answer to this suggestion it must be repeated here that whatever payments are collected through a military occupation must be in either gold or goods. There is no gold in the Ruhr industrial region; and if the goods are collected they must be disposed of outside the country, either in competition with French goods or with those of other countries. If France took upon itself the task of operating the German industries in the Ruhr district, she would be compelled to market the goods produced in that region in competition with the goods produced by her own citizens.

If France were to endeavor in a large way to reorganize all of German industrial life with a view to securing reparation payments, it would be necessary for her to balance the German budget, stabilize German exchange, and re-establish German commerce throughout the world. France has been unable to accomplish these things within her own borders; would she be able to accomplish the task in a hostile foreign nation, economically disorganized by the necessary inhibitions and abuses of a military occupation? It is safe to say that the military occupation of the Ruhr could not even pay its own expenses. It would only add to the burden of the French budget. It may be recalled in this connection that the first billion of reparation payments made by Germany last August was for the most part absorbed by the cost of maintaining the British and Belgian armies of occupation on the Rhine, and that France has thus far received no financial remuneration for the 1.2 billion marks expended on the army of occupation which she is maintaining in the Rhineland.

Destruction of Industrialized Germany

The main purpose of a French occupation of the Ruhr, however, would not be economic but military. If reparations prove a myth, then, it will be argued, Germany must be broken and destroyed as a potential industrial and military power, by seizing this nerve center of the German industrial and military system. Many believe that Germany's fate would thus be sealed, particularly if the Silesian industrial region goes to Poland. Stated in plain but cruel language, what is involved in the seizure of the Ruhr is the destruction of Germany as an industrial nation and the reduction of the country primarily to an agricultural status such as prevailed in the middle of the last century, a reduction which would involve the starvation or emigration to—God knows where—of some 10 or 15 millions of people. We have heard this grim eventuality advocated by men of high intelligence and sincerity as the only permanent solution of the European problem.

The argument in brief is that there can be no lasting peace and no permanent prosperity in Europe so long as the German menace exists. The German menace will exist so long as Germany remains an industrial nation. Therefore, Germany cannot be permitted to remain industrialized. Granted the original hypothesis, the logic appears incontestable. One must raise the query, however, whether France could carry through such a policy as is here foreshadowed.

In the first place, it is seriously to be doubted whether France, weakened in man-power as she has been by the war, could from a military point of view successfully carry out a prolonged occupation of Germany. On the economic side it would almost certainly prove disastrous to France. Not only would government expenditures be greatly increased; but the economic consequences of the dismantling of the

German industrial state and the attending social and political disorders in Germany would, as we have seen in Chapter XI on the unity of the problem, produce the most profound economic disturbance not only in France but throughout the world. The almost certain result would be an accelerated disintegration of the whole European economic and social system.

On the political side, the undertaking of such a policy by France would be practically certain to alienate her present allies. France's great strength in the last half-century has lain in her pacific attitude and in the support of other nations which this attitude has brought to her. Her policy since 1870 has been one of unaggressive self-defense. Her motto among the nations of Europe has been to live and let live. If now her motives change—if it becomes apparent that she is bent on military conquest, however great the provocation—she will find her former friends rapidly dropping away from her. Italy has already been estranged, and Great Britain would come to a definite break, since she could not countenance either the economic control in Europe which the mineral resources of the Ruhr, of the major portion of upper Silesia, and of Alsace-Lorraine would give to France, or the political hegemony which would follow in case France succeeded in the policy. Moreover, as we have seen, Great Britain would not be willing to join France in any undertaking designed to destroy German economic life, and with it English industrialism, which is dependent upon German trade. Finally, if France should thus take the bit in her teeth, the United States, it would seem, would be compelled to withdraw further from European affairs, leaving the continent to stew in its own grease. France would thus find herself isolated and disliked on every hand, just as Germany was before the war.

In the long run, moreover, such a policy would not give

France the military security which she desires. Few students of international affairs can be found who in their hearts believe that it would be possible for the French to dominate and control German economic and political life for an indefinite period. The French have not the requisite man-power or organizing power; indeed, no nation has the resources or the political capacity to police and control the life of a foreign nation of almost double its own population and developed to a high degree of industrial efficiency.

Part III—Remedies—Proposed and Real

CHAPTER XIX

THE LIMITATIONS OF FOREIGN CREDITS

A Tangled Net

"Any citation of the separate obstacles to economic recovery gives but an imperfect picture of the paralyzing influence of their concurrent action. Nor does it adequately represent the general disintegration and enfeeblement due to the breakdown of the exchanges and the international money famine from which the greater part of Europe is suffering. In once prosperous countries we witness today the rapid dissolution of highly complex economic organisms into low forms of primitive production, eked out by barter. In social pathology the disease may rank as general paralysis, a failure to function on the part of the nerve centers of the economic system. The full extent of the danger only now appears, when the hectic energy and artificial prosperity left by the war have died down, leaving a bewildered world struggling to restore out of its broken fragments the delicate and complex fabric of industry, commerce, and finance, which the Great War and Bad Peace have brought to ruin." [1]

The tangled net of international economic and political relations, which now binds in helpless confusion the peoples of the earth, must somehow be broken if the world is again to be set moving in the direction of economic and social progress. It is the task of the concluding division of this

[1] J. A. Hobson, in Report of International Economic Conference, London, October, 1920.

volume to suggest in broad outlines the policies or lines of action which the practical statesmen of the world must adopt if peace and prosperity are to be restored. We shall not presume to present a detailed program of reconstruction. In the light of our studies of the complicated interrelations of economic and political factors which constitute the problem, we realize, perhaps better than others, the impossibility of presenting at the present moment any completed program of reconstruction. Such a program can be formulated only after prolonged counsel among the practical statesmen of the world. What we may be permitted to suggest, however, is: (1) what things must be done; (2) who must undertake the things to be done; and (3) how they are to be accomplished.

This and the following chapter will be devoted to a consideration of two suggested remedies which have been proposed in various quarters and widely discussed during the past year. The first relates to the extension of further credits to Europe, and the second to the stabilization of the international exchanges. In conclusion we shall present what we conceive to be the requisite essentials of an international policy of reconstruction.

Argument for Extension of Credits

The extension of credits by the United States to Europe has been repeatedly urged as the only solution of the European problem. Immediately after the Armistice there were official suggestions of huge American loans, of 10 or 15 billion dollars, for reconstruction work in France alone. While the total figures have in the intervening months been gradually whittled down to more commensurable amounts, there has been—until recently at least—little abatement of confidence in foreign credits as the panacea for the European situation. In this chapter we shall review briefly the history

of foreign credits since the war, and point out the rigid limitations upon further loans as a solution of the European problem.

In the chapter on the foreign exchanges we found that the war had caused an enormous dislocation of international trade and financial operations. It will be recalled that the great increase in exports from the United States, as well as from neutral countries, resulted (1) in shifting a disproportionate quantity of the gold supply of the world to the United States; (2) in the resale to the United States of European investments in American securities; and (3) in the creation of huge foreign debts to the United States. In four swift years the United States was converted from the greatest debtor to the greatest creditor nation in the world. The outstanding effect of this shift in American trade and financial position has been to depreciate European currencies as compared with the American dollar. The outflow of gold contributed to the abandonment of the gold standard in Europe, while the disruption and maladjustment of international trade and the redistribution of international securities added to the depressing effects upon the European exchanges.

We have already seen that the three years that have elapsed since the conclusion of the war have only served to increase this maladjustment between the old world and the new. European domestic currencies, speaking generally, have still further depreciated; our trade exports have, until the last year, been even larger than during the war period; European loans from the United States have been increased by several billions of dollars; and huge additional quantities of gold have flowed from the depleted coffers of Europe to the banking institutions of the United States. In consequence the exchange situation is now as distressing a problem as ever, and international financial reorganization in

general is quite as far from accomplishment as at the time of the Armistice.

Even before governmental control of the exchanges was abandoned in the spring of 1919, numerous students of international finance had pointed out that the United States must increase its investments of foreign securities if depreciation of the exchanges was to be prevented. Depreciation of the exchanges, it will be recalled, is in part [2] caused by an excessive supply of bills of exchange. Now, whenever anyone in the United States invests in foreign securities he demands bills of exchange with which to pay for the securities purchased. Accordingly, if Americans will buy foreign securities in amounts equal to the excess of the supply of bills of exchange over the ordinary demand therefore, the total demand and supply will be equalized and exchanges will rise towards par. One must say *towards* par rather than *to* par, for the reason that actual parity cannot be attained until European nations are once more on the gold standard. Foreign investments are therefore looked to as a means of lessening the depreciation of the European currency. Moreover, American foreign trade would be facilitated by this appreciation of the European exchanges, for the disadvantage of buying in American markets would be lessened to the extent that the depreciation of the European exchanges as compared with the dollar was lessened.

It should be understood, at the same time, that these investments in foreign securities give to foreigners increased purchasing power and this enables them to increase to that extent their purchases of goods in the United States. Indeed, the making of foreign investments really means shipping goods abroad on credit. One should recall in this connection that the present huge foreign debts to the United States

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[2] In part, also, by depreciated paper money in Europe. See pages 20-21.

were largely created by the shipment of war materials to the Allied nations.

Such is the argument for an extension of American credits abroad. Most European countries still apparently need American credits. And America would like to extend the credits if possible, in order to stimulate our exports and thus revive industrial prosperity here. Foreign credits, therefore, appear to constitute a central feature in any program of international reconstruction.

Early Optimism

Before undertaking to discuss the main issue of this chapter—namely, how far foreign credits will now suffice to restore world prosperity—it will be helpful to survey briefly the history of American foreign investments since the war. The need of extending financial assistance to Europe was first strikingly presented in the United States by Frank A. Vanderlip, then president of the National City Bank of New York. In Mr. Vanderlip's view, if Europe were to recover from the enormous loss of the war and escape political and social disintegration, it was imperative that the wheels of industry be started by means of a vast loan from the United States. Since the security of individual European enterprises could not find a ready market with American investors, and since every portion of Europe must be given assistance if the spectre of bolshevism were to be effectively laid, Mr. Vanderlip urged that there must be a pooling of all European resources, whereby one gigantic loan might be extended to Europe as a whole, secured by a joint guarantee of the several European governments, with liens upon customs revenues as security.

Mr. Vanderlip's proposal fell upon deaf ears, partly because it called for a mobilization of world financial resources on a scale too stupendous for the average man to

grasp, but mainly because Mr. Vanderlip's views as to the gravity of the European situation were shared by few American business men. In the spring of 1919 the overwhelming majority of Americans believed that vociferously expressed optimism was about all that was required to restore the losses of the war. Did not the great need of the world for increased production provide the basis for a long period of intense business activity and prosperity for everyone? A pessimist—even an intellectual one—was regarded a national menace.

The Utilization of Banking Credit

Meanwhile credits continued to be extended to Europe. The government continued to make loans, the total increasing from less than 9 to approximately 10 billions in the year following the Armistice. In the main, however, post-war credits to Europe were extended in another way—one that had not been contemplated to any great extent, and one that on grounds of financial theory was not to be countenanced. American business men exported commodities on what were presumed to be short-term commercial credits. The exporters, as is the custom, financed their needs, pending the receipt of payments from abroad, by borrowing from the commercial banks. The process, of course, resulted in a great expansion of bank loans and in a rapid lessening of commercial bank reserves in this country. Europe was thus enabled to get the goods required, and American business received a great stimulus, one of the results of which was rapidly mounting prices.

We have said that the loans were presumably made for short periods only. It developed, however, that in consequence of Europe's inability to pay, these loans of bankers to American business men had to be renewed again and again—in fact indefinitely. The result was that for all

practical purposes they became long-term credits. These credits are still, in the main, owing to American business men, who in turn are still indebted to the banks for the amounts involved, which run into billions of dollars.

This process of extending credits, however, eventually ran its course. When the reserves of the federal reserve banks were reduced as a result of this and other causes to the danger point—that is to say, to a point beyond which they could not go without our passing from a system of gold redemption to one of inconvertible paper—it had to be altered. [3]

It was all along recognized by leading financiers and economists that this method of financing foreign trade was unsound and should not be allowed to continue even if it could. Europe wanted the goods, however, and American exporters wanted the sales; and with no other means of financing available, both exporters and bankers appeared willing to take the chance—small chance, it was assumed, because Europe was to come back with giant strides.

The Edge Act

The other possible means of financing Europe's needs was by long-term investment credits. Investment in foreign securities by the American people was severely hampered, however, because of inadequate financial machinery for the purpose. In brief, the American investor was unfamiliar with the merits of European securities, and was unwilling to assume the risks involved. What was needed was some means whereby he could invest in the securities of American financial corporations, backed by the European securities as collateral. European nations, particularly Great Britain, had long had foreign financing cor-

[3] There was also a bare possibility of a financial panic ensuing.

porations known as "investment trusts," which made it possible for British investors to invest abroad with a minimum of risk.

The principle underlying such financial institutions is in brief as follows: The foreign securities are purchased by the investment trust or financial corporation, and placed in trust as collateral security for its own bonds which are sold to investors within the country. The individual thus purchases the obligation of a well-known domestic financial institution rather than one of a relatively little known foreign corporation. Moreover, he is able to distribute his risks more widely; his security is in effect the combined earnings of all the foreign borrowers whose bonds are held as collateral security, in addition to the capital resources of the investment trust itself.

It was not until December, 1919, that the necessary congressional legislation could be secured for the formation of such financing corporations in the United States. The Edge Act then finally authorized the establishment of American investment trusts, popularly designated here as "foreign financing corporations." It was another twelve months, however, before any large effort was put forth to organize financing institutions under the provisions of the law. There had already been two or three financing corporations organized under state law, and early in 1920 one was organized under the Edge Law.

But the inability of these corporations—which were of only moderate size—to solve the problem became so apparent that in December, 1920, an effort was made to launch a huge foreign financing corporation, one that would be worthy of American financial genius. A capital of $100,000,000 was determined upon, which would make possible the purchase and sale of securities to the amount of one billion dollars. A nation wide campaign of education was

undertaken, with a view to enlisting the interest of all classes of business men, financial, manufacturing, commercial, and agricultural. Even the interest of laborers, as potential investors, was besought.

Almost another year has elapsed and this corporation has been unable to secure the necessary capital, owing to a combination of factors, including the business depression and the outright opposition on the part of many leading financiers. The chief objection to the plan is that the organization of a corporation of such tremendous size is unnecessary and even dangerous when it is by no means certain that there is any great volume of foreign security business in sight. It is feared, moreover, that it will be impossible to secure the personnel with which to administer so large and so difficult an undertaking.

One of the greatest difficulties on the administrative side is that of making certain that the securities offered are safe. Lack of definite knowledge of the standing of individual European borrowers is one handicap. But much more important is the general insecurity of conditions in Europe. The individual borrower may appear to be sound enough, both financially and morally. But the instability of the exchanges, the disruption of transportation, the disorganization of commercial relationships, social unrest and political instability, combine to multiply the risks which the lender must assume. Improved organization of the credit machinery of Europe is now universally conceded to be necessary if American credits are to be greatly extended.

In this connection it is noteworthy that none of the overseas financing corporations that have been organized by the largest financial interests in the United States have thus far succeeded in developing any appreciable volume of business. Without exception, they have found the practical difficulties of an insuperable character.

The "Ter Meulen" Plan

With a view to overcoming the present insecurity of European investments, there has been developed during the last year the so-called "Ter Meulen" scheme, named after its originator, a prominent Dutch financier. This plan has been indorsed by the International Financial Conference, which was held in Brussels in the autumn of 1920, under the auspices of the League of Nations. It has since been indorsed by the Council of the League of Nations, and by the International Chamber of Commerce at its conference in London, June, 1921. The Ter Meulen plan, therefore, is the next experiment in extending credit to the distressed nations of Europe.

In brief, the purpose of the plan is to encourage export trade by providing a special form of security, which will reinforce the credit of the European importers. The exporter, as under present conditions, seeks out his own customer in Europe, arranges the terms of sale, and investigates the credit standing of the buyer. But in order to improve his credit standing, and thus make it possible to purchase the goods required on more favorable terms, the importer approaches his government and borrows from it for the period of the credit "Ter Meulen" bonds, which he may use as collateral for his own promise to pay. Each borrowing government will arrange the conditions under which it will loan bonds to its citizens. But before the whole transaction is completed, the approval of an international commission, to be appointed by the League of Nations, must be obtained. This commission must satisfy itself that the imports consist of "necessary" commodities. It must also see that the total amount of bonds authorized for issue is not exceeded. Thus international, non-partisan, and presumably scientific, control is secured.

To make the credit sound it is obvious that there must

be satisfactory security back of the government bonds. The plan, therefore, provides that the governments which issue the bonds shall pledge as security revenue-producing assets (to which a gold value can be assigned) of sufficient amount to satisfy the international commission. It is suggested that the most suitable assets for the purpose would be export and import duties, and revenues from state railways, government monopolies, forests, etc.

According to the plan, in case the importer is unable to pay for the goods when payments are due, the exporter who has extended the credit may seize the collateral security —the Ter Meulen bonds—in satisfaction of his claims. These bonds he may then either hold as an investment or sell in the investment market. It will doubtless be provided, however, that if he wishes to sell the bonds they must first be offered to the issuing government, so that it may buy them in if it so desires. It should be added that these Ter Meulen bonds may be sold to American investors through the foreign financing corporations; or they may be pledged as collateral by the financing corporations against their own securities, which may be issued for sale to American investors. The rate of interest on these bonds will be fixed by each country. While all the details have not been determined—to our knowledge—it is suggested that the rate should be the normal rate that such country might expect to have to pay in the open market. The duration of the bonds will doubtless be from five to ten years.

It should be observed that the Ter Meulen scheme has three principal features. First, it permits, in large measure, the utilization of existing trade and financial practice and machinery. The export may be arranged as heretofore through ordinary private channels; and the Ter Meulen bonds may be marketed through the already established financial agencies. Second, it permits the greatest possible

amount of flexibility, allowing the methods to be adjusted to the varying conditions in different countries. Third, and this is the heart of the plan, it sets up machinery for placing back of the credit of the individual the credit of his government.

Not a Vital Remedy

What now is the hope from this Ter Meulen scheme? Will it solve the problem of overseas credit and thus make possible an early restoration of European trade and industry? After much discussion of this subject with financiers and economists both at home and abroad, we have been forced to conclude that the Ter Meulen plan will not prove of great importance. It is worth trying out if only for the lessons to be learned from such a trial. And here and there, no doubt, some credit will be extended through the aid of Ter Meulen bonds. But the plan will fail of accomplishing large results, for the reason that it does not reach to the heart of the European question.

So long as the budgets of European countries remain unbalanced, and so long as imports remain greatly in excess of exports, Europe will not be able to pay interest on Ter Meulen bonds. The revenues which are to be set aside for the purpose in hand are vitally necessary for ordinary fiscal requirements. When a nation's revenues are, for example, but half the ordinary expenses, it may conceivably prove possible for an international commission to appropriate what revenue there is for the payment of interest on Ter Meulen bonds. But this would not prevent a continuously unbalanced internal budget in the country in question and thus a progressive deterioration of the internal economic organization. On the contrary, it would intensify the budgetary difficulties. Now if budgets are not balanced, it will prove impossible to prevent the Ter Meulen bonds from

depreciating in value, thereby reducing their marketability in the investment markets. To present the question—What would have been the fate of German or Polish Ter Meulen bonds in the light of the recent fall in Polish and German marks?—is to answer it.

In consequence of considerations such as these, it is not at all certain that American and British exporters will be quick to try out the plan. While supporting the scheme as one that contains some possibility, A. J. Hobson, chairman of the British delegation at the June meeting of the International Chamber of Commerce in London, warned British exporters against too free a use of the plan. He pointed out that not even a stock exchange speculator would be willing to buy the securities of corporations which possessed a power of increasing without limit their outstanding obligations. So long as European governments have the power of unlimited issue of paper currency, the wise business man will proceed with caution in accepting Ter Meulen bonds.

American Investing Capacity

It remains to be noted that there is little chance that British and American investors, particularly the latter, will be either willing or able to absorb any considerable volume of Ter Meulen bonds. So far as England is concerned, her investment capacity has been enormously reduced in consequence of the staggering burden of post-war taxation.[4] As regards the investing capacity of the United States, it will be recalled that the credits extended to Europe during 1919-1920 were largely banking credits, the funds coming from bank loan expansion rather than from investment savings. Indeed, except during the war period, when, under the spur of large monetary profits and wages, and under the

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[4] See discussion on pages 131-133.

lash of the Liberty Loan campaign, we patriotically bought Liberty bonds and thus enabled the government to make loans abroad, the United States has shown little capacity to furnish foreign capital. It must be recalled that of the 10 billions of funds loaned by the United States government abroad, a very considerable per cent does not represent real savings, but only bank credit expansion.[5] Moreover, during the period of the war our investments in railroad, public utility, and housing enterprises were summarily curtailed. Looking ahead, there is little possibility of our financing overseas investments in addition to domestic requirements so long as business depression continues. And in case we have a business revival, the volume of domestic loans to be floated will severely tax our entire investment capacity.

It will assist to an understanding of the future of American foreign credits if it is clearly appreciated that it is an anomaly for a nation such as the United States to be in the position of creditor to the rest of the world. No nation before ever became a great creditor when its own internal industrial resources were so incompletely developed, as is still the case with the United States.

England, to take the best example of a "legitimate" lender of foreign capital, began to emerge as a creditor nation when the volume of her annual savings exceeded the requirements of her domestic industries. These excess savings then naturally sought overseas employment; indeed, they were *forced* to seek a foreign outlet. The machinery for making such investments, moreover, gradually developed to meet the needs of the gradually changing industrial and financial status of the nation. In a word, England arrived at her creditor position as a result of many generations of

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[5] See discussion of the process of war financing on pages 64-67.

gradual development; in consequence her economic organization was never thrown out of adjustment as a result of the process.

The present financial position of the United States is, however, fundamentally different. We have become almost overnight a huge creditor nation. As a result of temporary war demands, we forced the development of our manufacturing capacity much in excess of ordinary domestic requirements, and we were thereby enabled to repurchase European holdings of American securities and to extend the vast loans which converted us from a great debtor to a great creditor nation. We are now seeking to accomplish the impossible—to make permanent the foreign markets which the temporary exigencies of the war provided.

Moreover, as a creditor nation England had an unfavorable balance of trade, receiving the interest on her foreign investments in the form of an excess of imports over exports. The United States, on the other hand, is in the anomalous position of hoping to maintain a permanent large excess of exports over imports, at the same time that it receives interest on the huge foreign investments that grew out of the exigencies of war financing. We might as well attempt to make water run up-hill. In view of our excess manufacturing capacity and the present adjustment of our whole economic organization to the production of goods for export, we are not in a position to face the prospect of having interest paid in goods, with economic composure. The situation is fundamentally different from that of England before the war, where the position as a creditor nation was attained gradually as a result of normal trade and financial processes.

In any case it is idle to suppose that we could finance huge additional credits. Our own internal industries, particularly those that were neglected during the war, will con-

tinue to require substantially all the investment resources of the country. In the absence of the war there is little, if any, doubt that the United States would have continued to be a borrowing nation for many years to come. The events of the war have in no way changed the fundamental requirements of the situation; they have merely demoralized the trade and financial relations of nations and raised the most difficult problems of economic reorganization the world has ever known.

Factors in American Investment Situation

The American position with reference to future foreign loans was strongly presented at the International Chamber of Commerce meeting in London by George E. Roberts, vice-president of the National City Bank of New York. After observing that the United States is still a new and undeveloped country, and that over a large part of the country the people are accustomed to devote their savings mainly to the extension of their own immediate businesses, or to investment in local enterprises, he pointed out other reasons which render large additional American investments abroad impossible. He said:

"The competition for capital for domestic enterprises has made interest rates high, and the new offerings of securities at high rates has had the effect of depressing entire lists of outstanding securities and stocks, so that they yield high returns upon present prices. Other factors in the situation are the high rates of taxation, and the fact that municipal securities, to some extent, and bonds of the federal government are exempt from taxation. The total amount of securities wholly exempt now outstanding is estimated at approximately 15 billion dollars, and is being constantly increased by new issues . . . The presence of this large body of tax-exempt securities has the effect of practically elimi-

nating investors of high incomes as buyers of securities subject to taxation. To an individual of an income subject to our maximum tax rate, an exempt 4 per cent federal or municipal bond yields an equivalent of 14.81 per cent interest. Conversely, a taxable 7 per cent investment, such as a real estate mortgage, an industrial, or railroad bond, or a foreign government bond, after tax payments actually yields, under the higher schedules, less than 2 per cent. This calculation is based on federal taxes only, and there is local taxation to be considered besides."

These considerations take the wealthy investors out of the market for European securities, except at rates of interest which Europe would regard as utterly extortionate.

This fact, coupled with other considerations already noted, makes it impossible for the United States to finance Europe henceforth on any very extensive scale. All of our experience up to date confirms this judgment. We trust there will be no misunderstanding here; we are not contending that a great many millions may not still be extended. But the days of billions of overseas credit are definitely past, for at least a generation. The only possibility of extending the credits would be through a renewal of export sales on credits furnished through further bank inflation. In view of the fact that much the greater part of the credits thus extended are still unpaid, with American exporters and their bankers pocketing the losses, there is little likelihood of an extensive resumption of this process.

International Action Suggested

One further plan of extending foreign credits, already mentioned, has been frequently suggested, among others, by Frank A. Vanderlip, and by Sir George Paish, the former editor of the *London Statist*. In the view of these men the problem of Europe must be conceived as one problem;

that is to say, it is idle to talk of extending credits to this, that, or the other, particular individual in Europe, or to this, that, or the other, particular government in Europe. The problem must be dealt with on a continental scale; there must be a pooling of all European resources, whereby large loans may be extended to Europe as a whole, secured by the joint guarantee of the European governments. Sooner or later, it is believed, this will have to be done if Europe is to be saved. International action alone will suffice.

This is undoubtedly sound doctrine; because of the essential unity of the world economic problem. But we should still have to face the restricted absorbing capacity of the American (and British) investment markets. Such a loan, if it did not exceed a few hundred millions, might be absorbed in the course of a few years. If it ran into billions, it could not be handled.

Huge Credits Not the Principal Remedy

When all is said and done, the way out for Europe and the world does not mainly lie in huge additional credit extensions by the United States to Europe. No one can have an appreciation of the sources of disturbance in international economic relations until he clearly understands that the cause of the international maladjustment, including the depreciated exchanges, has been too much *buying* from the United States. European holdings of American securities have been traded for American goods; European gold has flooded the United States in exchange for American goods; and other billions of our goods have been shipped abroad on credit. The result has been an unbalancing of the economic and financial equilibrium of the world on a scale that no one before the war would have conceived possible.[6]

[6] The reader will do well to refer again to the table on page 19, which shows the extent to which the international scale-pans have been unbalanced.

The remedy for this malady is not more of the same medicine. Additional foreign investments by the United States will not bring the exchanges back to par; on the contrary, it will depreciate them still more. Temporarily, while exchange is being purchased for the purpose of making investments, exchange quotations may rise; but shortly—when interest becomes due—there will be a tendency toward still further depreciation. This might be, theoretically, offset by new foreign investments the year following—investments in excess of the interest charges on the old, and so on indefinitely. It is always recognized, however, that there must shortly come a time when our new investments would be less in volume than the interest on the old investments. When this becomes true, the net effect on exchange rates will be one of depression.

So much for theoretical possibilities. The practical situation is that we have already reached a point where new investments are not equal in volume to the interest on existing foreign debts. The only reason why the depressing effects upon the exchanges is not more fully manifest is that thus far we have not been asking foreign debtors to pay us interest. If we should insist upon the payment of interest on the foreign debt, European exchanges would immediately suffer heavy depreciation. In the words of George E. Roberts spoken before the International Chamber of Commerce in London:

"If in the present state of trade the United States should ask for the payment of accrued interest upon these loans and the debtor governments should go into the markets and attempt to gather up exchange to make the payments, the effect would be to raise exchange rates on New York still higher and bring our foreign trade to a standstill. In short, the United States cannot afford to accept payment of either interest or principal from the debtor governments at this time."

The economic rehabilitation of Europe and the restoration of international trade and prosperity is not, ultimately, to be secured by increasing our loans to Europe from 14 to 15, to 16, to 18, and to 20, and to 30 billions. Such a development would only intensify the world maladjustment which we are seeking to correct. All this is not to say, however, that there may not still be an interval of time during which Europe will have to borrow more. She may perhaps find it necessary to go somewhat further into debt before she can pull herself together and begin the process of getting out. But in the nature of things, Europe cannot expect to borrow much more. The several billions that have been borrowed since the Armistice have not placed Europe on her feet; on the contrary, every nation in Europe, England not excepted, is in a worse financial plight today than it was two years ago.

It is possible—though not certain—that conditions might have been still worse if we had not extended Europe huge post-war credits. Be this as it may, if Europe has nevertheless continued to go backward, the argument for additional credits loses all point—except as viewed from the standpoint of humanitarian considerations. Certainly, if some additional credits are to be granted, there must be absolute assurance that they will be utilized only for essential purposes, and not squandered on stupid consumptive extravagance, or in equally stupid military adventures, which only serve to intensify the political and economic instability of Europe. But more of this in the closing chapter of the volume.

CHAPTER XX

THE STABILIZATION OF THE INTERNATIONAL EXCHANGES

Factors Involved in Stabilization

As we have seen in the chapter devoted to the foreign exchanges, the fluctuations of exchange rates is one of the most serious obstacles to international trade, and hence to the economic recovery of the world. Ever since the fall and the gyrations in exchange rates began in the spring of 1919, economists and financiers have advocated stabilizing exchange rates. The need for, and the possibility of, stabilizing exchange rates was given prominent consideration in the Brussels financial conference of October, 1920. It was again considered at the meeting of the International Chamber of Commerce in London in June, 1921. Stabilization of exchanges is now being considered in the Western Hemisphere by the Inter-American High Commission. It has, moreover, been strongly urged that there should be held, in conjunction with the limitation of armaments conference in Washington, an international conference of financiers and economists on the subject of stabilizing the international exchanges.

In brief, the thought behind the stabilization proposal is this: If the value of the pound sterling, franc, lira, mark, etc., could be kept from fluctuating, it would not matter greatly that European currencies are depreciated as compared with the dollar. If international traders could depend upon exchange rates remaining for a reasonable length of time at a given level, it is believed that international trade would be revived regardless of the depreciation of the

various European moneys. There can, in fact, be no question that fluctuating exchanges enormously increase the risks of foreign trade, and there can in consequence be little doubt that a stabilization of exchange rates would prove a great boon to international trade.

It should be understood that the stabilizing of European exchanges involves, (1) a stabilization of the value of the paper mark, paper franc, paper pound sterling, etc., and (2) a stabilization of price levels within the several European countries. It was pointed out in the analysis of the foreign exchange mechanism in Chapter II, that there are two reasons for the depreciation of the exchanges—the unbalanced international trade and financial situation, and the depreciation of the paper currencies in the various European countries as compared with gold. If, therefore, the paper currency in any given European country is allowed to increase, as has continually been the case in central and eastern Europe, it will fall in value as compared with gold. On the other hand, if the paper currency within any European country is allowed to decrease, as has been recently the case in France and England, its value will rise as compared with gold. Thus it will be seen that it is a first principle that stabilization of the exchanges depends upon a prior definite fixation of the supply of paper currency and upon the stabilization of domestic prices in the several European countries. There must be neither inflation nor deflation.

Putting the Cart before the Horse

Now it is because of this principle, first of all, that stabilization of the exchanges is an impossibility. That is to say, it is impossible to begin the process of economic reorganization that is conceded to be necessary by stabilizing the exchanges. That is really putting the cart before the

horse. Those who urge the stabilizing of the exchanges as a solution of the world problem have begun at the wrong end. Several things must first be done before stabilization of exchanges can be accomplished; and when these things have been done the exchange question will in large measure take care of itself. They are as follows:

1. Exchanges cannot be stabilized until European budgets have been balanced. We need merely repeat here what has been shown in Part I of this volume,[1] namely, that so long as governments do not raise through taxation funds sufficient to meet current expenditures, a resort to the printing press is inevitable. And when further issues of paper currency are made, the value of all the existing currency falls as compared with gold; and hence exchange rates fall as compared with the American gold dollar.

It will be recalled in this connection that the form of inflation which results from government deficits has ceased nowhere on the continent of Europe; and that the recent decline in the total outstanding volume of currency in France is merely due to the fact that *commercial deflation* in recent months has been slightly in excess of the continuing *fiscal inflation*. As soon as commercial deflation ceases, the total quantity of currency in France, for example, will again expand in consequence of the unbalanced budget and the value of the paper franc will again fall in comparison with the value of gold.[2] In all the countries of central and eastern Europe, as we have seen, fiscal inflation far more than counterbalances the deflating tendencies of the business depression. In consequence the quantity of outstanding currency continues to increase by leaps and bounds. As one writer puts it, "Poland's outstanding note issues now amount

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[1] See Chapter X.

[2] For a consideration of other items affecting French exchange rates, see page 91.

to 100 billion marks. I lost track of Russian rubles at 85 billions; and Poland is but a pocket-borough as compared with Russia."

Because of the near worthlessness of most of the currencies of central and eastern Europe, those who favor stabilization usually insist that there must be a large measure of deflation in Germany, Poland, Austria, Hungary, etc., before any stabilization program should be undertaken. The value of the mark, crown, kopeck, etc., should be raised materially before attempting stabilization. In the light of these suggestions it will be interesting to give briefly the results of one or two attempts at deflation that have already been made.

Czechoslovakia undertook in the spring of 1919 to deflate the huge volume of Austro-Hungarian money in circulation, and at the same time to establish a national currency for the newly formed nation. The frontier was closed so that no outside currency could come into the country. The outstanding currency was then called in by the government, and 50 per cent of it was retained by the government. It was to be retired from circulation. For the remainder the government issued 50-year non-interest bearing government notes, stamped as Czechoslovakian money. Within a very brief time, however, it was found necessary for the government to utilize the other 50 per cent to defray government expenses, because the fiscal budget had not been balanced.

In 1920 Hungary called in its entire quantity of paper currency, ostensibly with a view to reducing its quantity. The Minister of Foreign Affairs was, however, responsible for the statement that it was the definite expectation that the government would use the retained portion for the purpose of defraying government expenses, that is, in meeting the deficit. He added that the amount retained would suf-

fice for about three months.[3] This expectation has been amply fulfilled.

2. Stabilization of the exchanges cannot be effected so long as European trade is seriously unbalanced. One cause of exchange depreciation, as we have seen, is the unfavorable trade balance of the various European countries. Fluctuations in the volume of trade also tend to cause fluctuations in exchange rates. Until trade between nations is again reestablished on something like a normal basis, it will be impossible to prevent fluctuation in exchange rates.

3. So long as international financial operations are out of gear, it is difficult to see how the foreign exchanges can be stabilized. Concretely, the foreign exchanges cannot be stabilized so long as European countries continue to increase their indebtedness to the United States through the medium of foreign loans, whether government or private. Immediately speaking, as we found in the preceding chapter, an extension of credit through increasing the demand for bills of exchange raises exchange rates. In a short time, however, the extension of additional credits tends to depress European exchange rates, for the simple reason that interest on the new loans shortly must be added to the burden placed upon Europe. Exchange rates are thus alternately bulled and beared.

4. Foreign exchange rates cannot be stabilized so long as reparations and Allied debts are required to be paid. As we have previously seen, the payment of reparation and debt instalments means a temporary bulling of the market, followed by a slump, which gives unusual opportunities for speculative manipulations. We may as well forget about stabilizing the exchanges, unless reparation and Allied debts are canceled. Unbalanced and unstable financial rela-

[3] The statement was made in a conversation with Mr. Bass.

tions between nations are incompatible with stable exchanges.

Finally, the attempt to stabilize the exchanges is merely another one of the vain efforts to find some one simple shortcut to world recovery. The very suggestion denotes once more the current failure to understand the unity of the world economic and political problem. Each link in the chain of economic and political relations supports every other. Just as unbalanced trade has helped to depreciate the exchanges, and as the depreciated exchanges in turn have helped to unbalance trade; just as unbalanced budgets have served to inflate the currencies, and in turn as currency inflation has increased the budgetary difficulties; just as the granting of huge loans to Europe has thrown the economic balance of the world out of gear, and as the attempt of European nations to pay debts and indemnities further unsettles international trade and financial relations—so also the return to international economic stability depends upon manifold factors. Stabilization of the foreign exchanges depends upon stabilization of domestic prices; stabilization of domestic prices depends upon controlling paper money issues; controlling paper money issues depends upon the balancing of budgets; and the balancing of budgets depends upon both economic and political stability in international relations. All these elements must in turn contribute to the re-establishment of domestic production and to balanced international trade, and thus to the desired stabilization of exchanges. But stabilization of the exchanges would then already be an accomplished fact.

CHAPTER XXI

THE WAY OUT

Four Basic Requirements

In outlining the policies that must be pursued by nations if recovery from the effects of the war is to be brought about, we shall largely build upon principles that have already been enunciated and elaborated in the course of the discussions in preceding chapters. There appear to be four basic requirements in the situation, four things that must be accomplished if the existing processes of dissolution are to be overcome and the world again set in the direction of economic and social progress. First, domestic production must be increased in every country. Second, relatively unrestricted and balanced trade between nations must be re-established. Third, the gold standard must be restored. Fourth, the budgets of European countries must be balanced—balanced in the sense that expenditures do not exceed receipts from taxation. We do not mention the cessation of inflation as a separate thing to be accomplished, for, as we have seen in Chapter VIII, inflation is now largely a result of unbalanced budgets. These are the four outstanding requirements; it may safely be said that if these four things are secured, the economic world as a whole will again be on its feet.

I. Domestic Production Must Be Increased

Price Readjustment

An increase in domestic production is obviously very intimately related to the restoration of international trade. Nevertheless there are certain requirements which must be

fulfilled within each nation independently of the restoration of foreign trade. If productive output is to be increased, something more is necessary than a change in the attitude of labor; something more is necessary, also, than the mere enunciation of the old doctrine that what we must do is to work and save. Opportunity to work and to save is now both in Europe and the United States the all-important requirement.

Any discussion of domestic production, of course, raises immediately the problems of the business cycle. If production is to be materially increased, somehow the back of the depression must be broken and the wheels of industry must again be set in motion. In Chapter IX, "How Long Will the Depression Endure," especial emphasis was laid upon the maladjustment in prices that now exists as between the various groups of commodities. It will be recalled that agricultural prices at the farms are now in general at practically pre-war levels; and that, on the other hand, the prices of many important groups of commodities are still far above pre-war levels. If the conclusion in Chapter IX is sound, namely, that there cannot be a real revival of industrial prosperity until such time as agricultural purchasing power is restored, then the first step in any program for re-establishing the fundamental conditions of prosperity must be a reduction in the prices of those groups of commodities which have thus far declined relatively little.

If it be objected that in view of costs of production such commodities cannot be reduced in price, it is answered that what has occurred in other groups of commodities can occur in these commodities; indeed, it must occur before prosperity can again be resumed. However painful the process, liquidation must run its course in the lines where it has not yet occurred. There is, moreover, nothing to be gained by unduly slowing down the process of liquidation. The sooner it occurs, the sooner will the necessary foundation be laid

for a resumption of industrial activity. It may be noted that the process involves a further liquidation of labor in numerous industries, as well as a reduction of transportation rates. These reductions, moreover, must be passed through to the final consumer in the form of lower retail prices.

Supplying the Initial Stimulus

After prices and costs have been reduced in the lines that have thus far resisted the forces of liquidation and a rough price equilibrium has been established, then some stimulus must, if possible, be applied that will give the stalled industrial machine the necessary initial whirl that leads to general business resumption. In this connection, the inauguration of a program of public works by federal, state, and municipal agencies appears to be much the most feasible means. The demand for materials thus created would stimulate certain lines of activity; and in turn the workers thus given employment would, through purchases at the retail stores, stimulate a demand for commodities generally.

It should be distinctly understood, however, that no program of public works will suffice to bring a complete resumption of business activity so long as the whole international situation remains in chaos. What we are suggesting here is but one of several necessary steps in any program of world economic recuperation. Without a restoration of international trade and without a balancing of budgets in European countries, the stimulation of public works will accomplish relatively little.

II. Balanced International Trade

Economic Argument for Cancellation of Allied Debts

We have seen in Chapter XI that the modern world is an economic unit and that there can be no genuine prosperity

anywhere so long as any important section of the world is economically and socially disintegrating. We have seen that the restoration of productive activities in the United States is in large measure dependent upon the restoration of European buying power. We have found in Chapter XV, "The Economics of the Reparations Problem," that balanced trade is fundamental to the successful operation of the modern system of specialized production and exchange between nations. We have seen in Chapter XIX, "The Limitations of Foreign Credits," that a restoration of international equilibrium is not in the long run to be attained through piling up further European debts to the United States. If Europe is to revive and if the international financial system is again to be brought into normal adjustment, European exports must be expanded relatively to imports. These principles lead inevitably to the conclusion that European government debts to the United States government should largely be canceled. The matter of European obligations to private individuals in the United States involves somewhat different considerations and will be discussed later.

It is good business for the United States to cancel European debts. The issues involved have been fully set forth in a preceding chapter, but for the sake of emphasis they may be restated here. There are three ways of looking at the problem:

First, let us assume that Europe buys as usual from us, but exports to us the usual amounts plus the amount of indebtedness. This would seriously disorganize our domestic industries. Ultimately—after a period of severe business depression—the labor and capital employed in the disrupted industries might find occupation elsewhere. But by the time approximately such readjustment was effected, another readjustment equally disturbing would be required, that is, upon the conclusion of the debt payments.

Second, let us assume that Europe cannot increase her exports to us by the amount of the indebtedness and must in consequence utilize existing exports for debt payments. In view of European economic conditions this is undoubtedly what will have to occur if we insist upon payment. This will mean, however, that European imports from the United States will be curtailed to the extent that European exports are commandeered for debt payments. Concretely, if Europe ships us $1,000,000,000 of goods annually as payment of interest and principal on past debts, she will be unable to buy from us $1,000,000,000 of commodities of current production. We shall have to take our choice between allowing Europe to ship us goods in payment of past obligations or allowing her to use such goods in purchasing future American exports.[1] We want a restoration of balanced trade. There can be no genuine recovery of business until normal trade relations are re-established; and normal trade relations cannot be re-established so long as wholly abnormal international debt payments are insisted upon.

Third, let us assume that through the exercise of the enormous power and influence which we now possess in the world, we should bring sufficient pressure to bear to compel Europe to make Herculean efforts to pay. Under present or early prospective conditions we will merely be compelling European nations to resort to further domestic inflation, and thus still further disrupt European currencies and exchanges, even as German currency and exchange have succumbed under the recent pressure of the Allies for reparation payments. The resultant effects upon American trade and industry are so obvious, in the light of preceding discussions, as to require no discussion here.

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[1] For the effects upon the American tax burden, see pages 234-237.

Moral Reasons

There is, moreover, another reason why we should cancel the greater part of the Allied indebtedness. By so doing we can both regain our traditional reputation for fair dealing, and promote a new spirit of co-operation in the solution of world problems. The truth is that the greater part of the European debt was contracted between the date of our entrance into the war and Armistic Day. Unable immediately to place large armies in the field, we were nevertheless equipped to furnish the supplies and munitions of war, without which the Allied armies must have succumbed before American man power could have been placed in the field. Every consideration of fairness and square dealing requires that we count these loans as a part of our contribution to the war. There is no more reason why we should charge the Allies for the materials and supplies required than for the cost of our army, or for the loss of our men after they actually got into the field—unless, indeed, we prize our dollars more than we do our flesh and blood.

Additional light is thrown upon the ethical issues involved, by the fact that even before our entrance into the war and the granting of official loans by the United States government, Europe had parted with roughly a billion dollars' worth of gold in purchase of American goods, had resold several billion dollars' worth of American securities to the United States as a means of purchasing munitions and supplies, and had contracted huge loans in the United States through the ordinary private financial channels. Whatever the merits of the controversy as to when, precisely, it became our official duty—or when it became politically possible—to enter the war, the fundamental fact cannot be ignored that at least from the time of the sinking of the Lusitania on, the war was America's concern. The truth is that Europe had utilized practically all of her avail-

able resources in purchasing supplies in the United States before the United States officially entered the war. From then on, the only possible means of procuring requisite materials was through borrowing. The war would have been lost if we had not furnished what was needed. There is not the slightest justification now for us to insist that these are real obligations of Europe to the United States.

It should be emphasized, lest there be misunderstanding, that this moral argument applies only to that portion of the ten billions of government debt which was incurred for strictly military purposes. It would not be particularly difficult to differentiate between war and non-war loans before the Armistice. Since the Armistice, of course, none of the loans made were for war purposes. A rough estimate of the total of war loans is seven or eight billion dollars.

Private versus Public Creditors

Debts of European governments and European individuals to private individuals in the United States stand in a very different light. While from the standpoint of international trade the problem is practically identical with the question of government debts, from the standpoint of moral obligations and the future of foreign credits it is essentially different. If the claims of American business men against European governments and European corporations were to be annulled, the effects upon future credit operations might prove most detrimental. We believe that the recommendation the United States Chamber of Commerce made at the International Chamber of Commerce meeting in London, to the effect that international debt obligations should be maintained because of the necessity in these unsettled times of adhering steadfastly to the sanctity of contracts, is sound so far as it relates to private obligations. The cancellation of European government debts upon our own initia-

tive would, however, in no sense be repudiation. In the first place, it would be in response to the voluntary suggestion of the creditor; and in the second place, it would be in recognition of the fact that we have no good moral claim for goods delivered during the war.

Moreover, we do not believe that there is anything in the contention that if we now annul the government debts incurred during the recent war, in the event of another war the United States would be unwilling to furnish the credits then required. While this argument may be sound as applied to private credit, it cannot be taken seriously with reference to government credits. If the United States were again menaced by German, or other aggression, and if we were compelled to enter another war in defense of our national rights, not to mention democracy, there need be no fear that we should refuse to furnish the military supplies and munitions required by our Allies as well as by ourselves. The only possible difference would be that the next time we should not call it a debt which our fellows in arms owe to us.

New Reparations Settlement Required

The same general conclusion is applicable with reference to reparations. If recovery of world trade and a return to prosperity is desired, a complete change of front on the part of the Allied nations with reference to reparations is necessary. We have seen that it is impossible for the Allies to obtain reparation money with which to defray pensions, etc.; we have seen that the only way in which any substantial volume of reparations can possibly be paid is through the export of goods into Allied countries.

The present absurd method of figuring reparations in terms of money should be given up. Germany cannot pay in gold, or other money, and the sooner this is openly recog-

nized by the governments of the world, the better. Each nation should designate precisely what commodities it wishes Germany to deliver and in what volume it is willing to receive the commodities designated. We have seen that in the Rathenau-Loucheur agreement France has finally drawn up a statement of specific commodities that she is willing to receive—or more accurately speaking, that the reparation experts think France is willing to receive.[2] Whatever may be true of reparation adjustments which are already in process, in the long run payments in kind should constitute all the French reparations. Any other means of payment, as we have seen in our previous analysis, is either altogether mythical or else at the direct expense of the other Allies. Meanwhile if England can think of any commodities that she desires to have shipped in from Germany free of charge, she should draw up a bill of particulars; and the same, of course, holds for Belgium, Italy, Serbia, and Roumania. Since Germany can pay only with goods, the total of goods actually desired by Allied nations should constitute the maximum demands made upon Germany. Any additional money demands are, under present conditions, a mere travesty on human intelligence.

Moreover, in deciding upon the amount of commodities which they desire Germany to furnish as reparations, the Allies should bear in mind two all-important considerations. Assuming France might be willing to receive, during the next three years, materials, supplies, etc., valued at, say, 7 billion marks, it does not at all follow that it would be to the best interests of France to compel Germany to furnish such a total. In the first place, if the strain thereby placed upon Germany resulted in the breakdown of the German financial and economic system, the disastrous effects upon

[2] It remains to be seen, it will be recalled, whether the French Parliament will sanction the proposal. See discussion in Chapter XVI.

French industry would far more than outweigh any possible attending gains to France. In the second place, even if the German economic system did not succumb under the strain, one must still appreciate, if he is to appraise correctly the effect of reparation payments, that when Germany is compelled to export goods to France or other countries in settlement of reparation obligations, she is prevented from using those commodities in buying the exports of France and other countries. France and Britain and Belgium and Italy and Serbia and Roumania need to have Germany buy from them quite as much as they need to have German materials furnished free of charge. And from the point of view of European industry and trade as a whole, there cannot be the slightest doubt that specialized production within the various countries and a balanced exchange of commodities between nations is the paramount requirement for every nation involved. A recognition of the importance to every nation of German markets and of the necessity of enabling Germany to use her own exports as a means of purchasing imports, if German markets are to be restored, leads inevitably to the conclusion that reparation payments must be reduced to negligible quantities for the good of the Allied nations themselves.

Campaign of Enlightenment Necessary

What hope is there for economic recovery in the world so long as the Treaty of Peace and the settlements made thereunder stipulate, on the one hand, that the "hole in the west" must be kept open, that Germany must not reduce her imports of non-essential or other commodities; and, on the other hand, require that Germany must use all the possible exports that she can deliver as a means of paying reparations rather than as means of buying the goods which Allied nations are so desirous of selling? What hope is there for

the world so long as the leading premiers of Allied countries admit that Germany can pay only with goods which none of the Allied nations are willing to receive, and give support to their parliaments in framing tariff measures designed to prevent German exports; and at the same time insist that recalcitrant Germany must meet the reparation obligation to the last farthing and the last sou? What hope is there for the world so long as most of the leading students of international finance and economics, who recognize the fundamental illusion in reparations and Allied debts, will frankly discuss the subject only in undertones and in inner offices? What hope is there for the world when statesmen and financiers alike, while lacking the courage to tell the truth about reparations and inter-Allied debts, insist that nothing can be done as a practical matter, "however desirous it might be from an economic point of view," because the people will not be satisfied to give up the supposed advantages of reparations and of debt payments? If ever there was a time for leadership in a campaign of enlightenment on the fundamentals of international economics, it is now. If ever there was a time when the truth is needed to set men free, it is now. If ever there was a time when evasion, concealment, and pussy-footing were political virtues, it is *not* now.

Trade Barriers

Quite as important as the cancellation of huge debts and indemnities, is the elimination of trade barriers in order to permit a resumption of normal buying and selling between nations. The world wants trade, with emphasis on the *trade*—imports as well as exports. If the statesmen of the world do not by this time realize that the world as a whole cannot export more than it imports, and that no nation can continue to export unless it imports goods of approximately the same value, then there can be no hope for

extensive trade resumption. Protection may be all right in theory; but it will not work in practice, as the last two years have conclusively demonstrated. Economically speaking, the world needs, more than anything else, the resumption of specialized production in accordance with the varying capacities of nations and the unrestricted exchange of commodities between countries.

There has been since the war a return to a regime of trade control and tariff regulation comparable only to the situation during the mercantilist era of the seventeenth and eighteenth centuries. Then the guiding principle of all nations was to develop national power through a series of trade regulations and restrictions designed to promote manufacturing and to make the exports of every nation exceed the imports, with a consequent perpetual inflow of specie. The new mercantilism is in some degree directly attributable to the terms of the peace treaties. For example, the treaties provided for the establishment of numerous and sundry new nations in central and eastern Europe. In the formation of these new nations the peace conferees sought the advice of historians, with much knowledge of emotional history reaching back to the Middle Ages, but with practically no understanding of the modern economic interdependence of nations. Each of these states has since been trying to render itself economically self-sufficient—through trade embargoes, restrictions, and tariffs; each has, however, merely succeeded in rendering itself economically impotent.

Says the British Commercial Commissioner to Hungary: "The conviction is indelibly printed in one's mind that the sole possibility of the States arising out of the former Austro-Hungarian Empire regaining anything approaching their former stability and becoming of use to the rest of Europe is for them to work together in some form or other. It is impossible for them to continue to be close preserves

and prosper; they are dependent on one another. The trade barriers which have been set up on all sides will have to be removed. In surveying the past year, it would seem that each State has determined to prevent the others from existing, even if it ruined itself in the endeavor." [3]

It is not merely trade barriers that impede economic recovery in central and eastern Europe; transport barriers are almost as bad. Through freight lines have been broken up; trains are unloaded at the boundaries and the goods transshipped at great expense, partly as a device for making work, partly as a means of obtaining enlarged customs revenues, partly through fear that if cars were allowed to cross the frontier they would never be seen again, and partly from mere bureaucratic stupidity. An excellent example of the last named is found in the recent refusal to allow a fire engine to cross the Austrian frontier into Italy to extinguish a blaze in a railway depot, for the reason that the fire company had no passports. The station was burned.

The nations of western Europe, Australia, and the United States have been following similar trade policies. Emergency and anti-dumping bills are advanced to prevent the destruction of domestic industries threatened by the payment of debts and reparations, when what is really required is the stimulation of domestic industries through a restoration of balanced trade between nations. We do not urge that absolute free trade between nations should immediately be established. But we do insist that the erecting of additional tariff barriers and trade restrictions at this time would result disastrously to the industries of all countries, and that gradual reductions of duties everywhere would be enormously beneficial to all concerned.

There is a growing appreciation among the more en-

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[3] R. J. E. Humphreys, in *Board of Trade Journal*, June 9, 1921, page 638.

lightened business men of this country that protectionism has gone to seed. Witness the vehement protest from bankers, merchants, and even from many manufacturers against the American Valuation Plan, designed to bar foreign goods. It is increasingly recognized that if we expect to export, we must import.

Special Privileges in Foreign Trade

The same forces that have been responsible for the creation of tariff barriers have impelled governments to lend their support to large industrial and trading combinations seeking the control of foreign markets. The more powerful nations are compelling the weaker ones to grant by treaty certain monopolies and special privileges within their territories. An instance is found in the recent treaty between France and Poland under which Poland has agreed to give France exclusive mining rights and special tariff privileges. Against this pact the United States has entered an official protest. There are a large number of such international agreements in Europe by which special advantages are given to one nation or another. This tendency to eliminate equal opportunity, or the "open door," in international commerce, receives additional impetus through the organization of big business combinations or trusts which have grown up during and since the war.

An example of the union of government and business is found in the support given by the British government to the efforts of the Shell Company at world monopoly. The government is financially interested in subsidiary companies of this oil monopoly, which possesses properties and exclusive rights in many foreign countries. The Shell Company has secured control of the Royal Dutch Company and seems to have thus got a monopoly in the Dutch colonies. At the political conference held in San Remo in 1920, the

French Prime Minister ceded to Great Britain the oil fields of Mosul, which are located in the territory claimed by the French under the peace settlement. Additional grants were made to the British of exploitation rights in Madagascar and Morocco. All these monopoly grants, it appears, are now controlled by the British Shell Company. The British government, moreover, has secured by treaty from Persia the exclusive rights for developing the oil fields of that country. The Persian Oil Company which the government helped to finance has also, it seems, been absorbed by the trust. Finally, there is an agreement between the French and British regarding the oil fields of Galicia, the details of which have not yet been published; and it is reported that the British Shell Company has also secured practical control of the Roumanian oil fields. Such methods of conducting international commerce are a menace to the future peace of the world. They must be abandoned, to make place for equal individual trade opportunity regardless of nationality.

It will be seen that these attempts to expand exports through lending government financial support to huge exporting corporations are diametrically opposed to the policy of restricting imports through the imposition of tariff barriers. What a tragedy it is that most leading governments of the world are seeking simultaneously to expand exports by granting special monopolistic privileges and to reduce imports through restrictive tariff legislation! Millions of people are already paying, in unemployment and starvation, the penalty of this stupidity.

Further Credit Extensions

In Chapter XIX, "The Limitations of Foreign Credits," it was pointed out that the solution of the European problem does not lie in huge additional American loans. Further extensions of credit to Europe merely tend to increase the

international maladjustment which we are seeking to remedy. It was admitted, however, that the economic plight of Europe has become so desperate that some further credits may for a time be needed by certain countries.

Further foreign loans must, however, be granted on essentially different terms than has been the case heretofore. We have already extended several billions of credit to Europe since the war, very little of which has been devoted to genuine reconstructive work. We have made loans to France, for example, while France was using her money to finance Polish military adventures. For that matter the United States has also furnished Poland munitions on credit. We have, moreover, extended credits everywhere for relatively non-essential uses. Loans for such purposes must be summarily discontinued.

It is idle, moreover, to grant loans to any particular individual or corporation in any given country, if the financial and economic condition of that country is fundamentally unsound. Hauser in Vienna or Jabiski in Prague may be ever so trustworthy and of first-rate business ability; but if governments become insolvent, and the financial and economic system disintegrates, the credit of individuals is worthless. It is equally fruitless to extend credits for the financial rehabilitation of Poland, or Austria, or Roumania, or any other isolated country. If countries roundabout Austria collapse, all the credits in the world cannot prevent Austria from traveling a similar road. Europe, at least continental Europe, must be envisaged as a credit unit if further loans are to be either safe or beneficial.

III. The Gold Standard Must Be Restored

Effects of Depreciation

Before European and hence world economic prosperity can be restored, there must be a re-establishment of the gold

standard in at least all of the leading commercial nations of the world. As we found in Chapter VI, every nation in Europe was forced during the war to abandon the gold standard, that is to say, it was forced to give up specie redemption of paper currency upon demand. All European nations without exception are still on the paper money basis, and with few exceptions the paper currency is now depreciated much more than it was even during the war period. The results of this depreciation of paper currency are manifested in fluctuating prices, hesitant business, and labor and social unrest in every country; while in some countries the steady monetary deterioration is causing a rapid disintegration of the entire economic system. Moreover, European paper currency, with its fluctuating value, is a primary factor in the oscillations of the exchanges which so disorganize international trading operations. There can be no real stability in domestic business within the several European countries, and no stability in international trade and finance, until the redeemability of paper currency in gold is once more re-established. Interchangeability of gold and paper currency is necessary.

Repudiation Lesser of Evils

Suggestions have been made by many people since the war that the gold standard should be permanently given up and that some substitute should be found. There have been suggestions of paper units of value, of other commodity units of value, of labor value units; and many there are who believe that money should be abolished altogether, and that we should return to the good old days of barter. Attempts to return to a form of barter in international trade have in fact been made; but they have not proved successful. The other suggestions, moreover, are altogether visionary. The only practical way out of the present monetary chaos is

to effect a return to the gold standard—not because the gold standard is perfect, but because it offers the only hope for reasonable financial stability.

The gold standard cannot be re-established in most of the nations east of the Rhine, including Germany, Austria, Hungary, Poland, Russia, and the Balkan states, by any normal process of deflation or reduction of the outstanding paper issues. The difficulties involved in retracing the financial footsteps that have led from the gold standard to the present inflated condition have already been discussed in Chapter VII, "The Impending German Monetary Collapse." As a practical matter, moreover, there is no use in attempting to stabilize these currencies at some new parity with gold, that is to say, to redeem 50 paper marks, or 1,000 paper kronen, or 50,000 paper rubles in one gold mark, gold krone, or gold ruble, and then again reissue them. The huge volume of outstanding currency should not be retained by any process of redemption and reissue. The illimitable quantities of worthless paper should be destroyed in carload lots, and with it should be obliterated the whole tangle of artificial financial values that has grown up during and since the war.

In all of these countries there must be a virtual repudiation of the whole mass of bank note, government bond, and other obligations. The entire situation is so utterly fictitious and so utterly impossible of control that there can be no stability and certainty in business and financial affairs until after the slate has been wiped clean and a new start has been made. There are difficulties and consequences staggering to the thought in repudiating the enormous volume of paper currency in the nations of eastern Europe. Nevertheless repudiation is the lesser of evils and in the end it will be found the only way out for these nations. There is nothing to be gained and everything to be lost by prolonging the agony.

Repudiation need not, however, be absolute. It would no doubt be wise to redeem outstanding obligations at the rate of 50, or 100, or 500, or 1,000, or 10,000 to one, the proportion varying of course with the amount of paper currency outstanding in different countries. Bear in mind that this suggestion of redemption differs from the one above; for it involves cancellation after redemption instead of reissue. It will be seen that while individual wealth as expressed in terms of currency will thus be scaled down enormously, prices will also be scaled down, and hence standards of living will not be directly affected.

In this connection it may be interesting to recall that at the time of the formation of the United States government, Alexander Hamilton, as Secretary of the Treasury, undertook the redemption of the outstanding colonial paper issues, a legacy from the Revolutionary War, at a rate of 100 to 1. Only a very small percentage of the total was ever actually presented for redemption in specie. This would undoubtedly be the case in the nations of eastern Europe at the present time.

So far as Italy, France, Belgium, and Great Britain are concerned, repudiation of outstanding government and bank obligations is doubtless unnecessary, provided certain other measures are adopted. We found in Chapter VI, "The European Monetary Situation," that bank reserves in these countries are very low as compared with pre-war times, and that with the exception of Great Britain a return to specie payments, in the absence of world financial co-operation, is practically impossible, at least for a great many years to come. If the gold standard is to be restored in these countries, it is necessary to work out some plan of international action whereby their gold reserves may be replenished.

This is, of course, also true of the nations east of the Rhine. After the huge mass of present outstanding paper

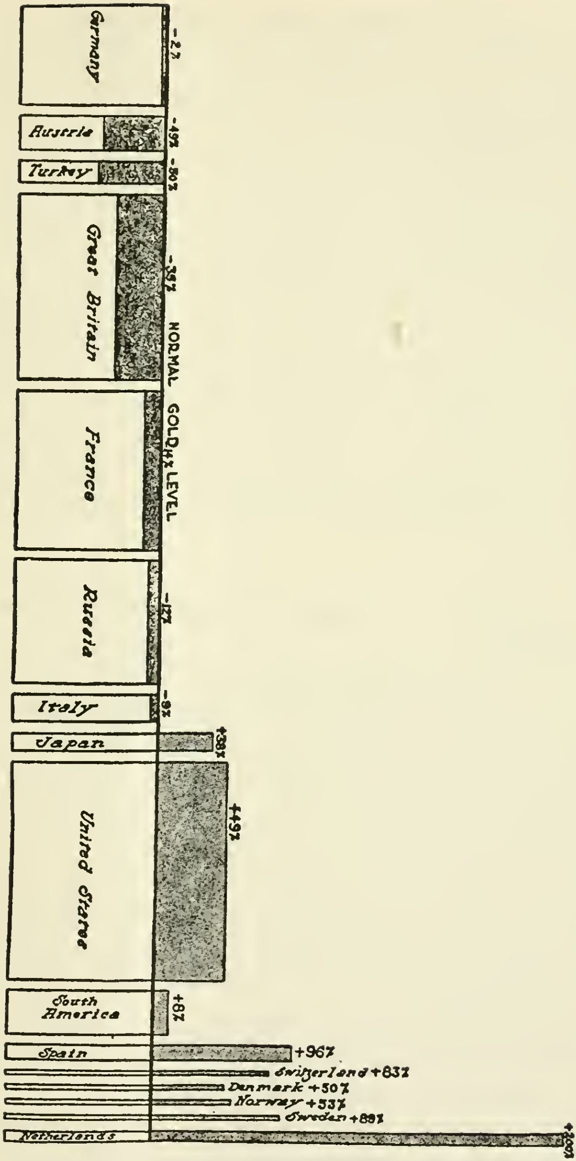
currency is obliterated, new paper issues will have to be made on the basis of adequate gold reserves, in which the paper will be redeemable. One of the outstanding tasks of the world today, therefore, is to redistribute the world's gold supply in such a way as to make possible the restoration of the gold standard in all of the leading nations.

Redistribution of Gold Supply Since 1914

To understand why a redistribution of the world's gold supply is now required, one must appreciate the effects of the war upon the allocation of gold among the leading commercial nations of the world. Before the war the world's gold supply, as a result of trading and financial operations extending over many years, had come to be distributed among commercial nations in rough proportion to their relative needs, that is to say, in proportion to their relative commercial importance. The accompanying diagram indicates the distribution of the world's gold supply on January 1, 1914, and again on January 1, 1917.

The relative sizes of the several rectangles in the diagram below the normal gold level line indicate the relative share of the total gold supply that each nation possessed in 1914. The shaded areas below the normal gold level line indicate the percentage decrease in the gold supply of belligerent countries shown in 1917, while the shaded areas above the normal gold level line indicate the percentage increase in the gold supply of neutral countries shown in the same year. From January 1, 1917, until the end of the war, there was relatively little change in the distribution, for the reason that embargoes were placed upon gold exports by all the leading European countries. [4]

[4] The liberal use of gold as a means of purchasing war materials in neutral countries was threatening to undermine completely the European monetary system; hence the embargo and the resort to borrowing.



World Gold Distribution in 1914 and 1917

Some important changes have occurred since the war. Germany has lost more than half of the gold supply which she possessed at the time of the Armistice; and Russia has probably lost the greater portion of her supply. In 1919 the United States had a large outflow movement, mainly to South America and the Orient; but in 1920 the tide turned and we have since had a large monthly inflow from nearly all quarters of the globe. During the current year (1921) the importations of gold have been enormous, amounting from January 1 to September 10, to $509,907,516. A golden flood has swept into the country, like that of 1916, when Europe was parting with her gold supply in the purchase of indispensable war materials. With gold coming to the United States at the rate of $750,000,000 annually, it would require only about eight years completely to denude Europe of gold.

Return of Gold to Europe through International Co-operation

One of the most sinister factors in the world international situation at the present time is this continuous outpouring of gold from Europe. While most of the commercial and some of the financial press of the United States have been pointing to the increase in our gold supply as a favorable factor in the American situation, it has all the time been one of the most unfavorable of symptoms. The inflow does not do the United States any direct good. The gold is steadily piling up as excess, unnecessary reserve money in the vaults of our banking institutions. The only way in which it may be said to have been helpful to us is through alleviating the temporary banking strain of last year and in easing interest rates. On the other hand, the loss of this gold supply has meant continuous financial deterioration in European nations. It has tended to depreciate further the paper currencies of the

countries involved, and it has postponed the day when these nations could hope to resume specie payments.

Before a restoration of specie payments can be accomplished, the gold tide must set in the opposite direction. Germany, Austria, Russia, Great Britain, France, Italy, and other belligerent countries must have their gold reserves replenished. This gold must come from the United States and the neutral countries, which now hold such disproportionate quantities of the total world supply. Under normal processes, nations whose stocks of gold are depleted can replenish their reserves only by maintaining an excess of exports over imports, the balance being paid by shipments of gold. In case international debts and indemnities of huge proportions are allowed to stand in the balance against the belligerent countries of Europe, the exports of these countries would of course have to exceed their imports by more than the annual amount of the indemnity and interest charges, before they would receive a net inflow of gold. This consideration is an added argument for the cancellation of inter-Allied debts and indemnities.

These normal processes are, however, too slow to accomplish the ends desired. International trade and international finance must be quickly restored if further economic disintegration is to be avoided. The practically worthless currencies of central and eastern Europe must be virtually repudiated, and the outstanding issues of the nations of western Europe must be reduced by further commercial liquidation and held in check by the balancing of budgets. When this is done an early return to specie payments may be effected through international financial co-operation, whereby a redistribution of the world's gold supply is made in accordance with the monetary requirements of nations. In this connection, Secretary Hoover and Comptroller of the Currency Crissinger have both recently suggested some form of

international co-operation among the great central banks of the world, whereby the gold supply may be pooled for the benefit of the commercial and financial world as a whole.

Two methods of accomplishing the end desired may be suggested. One is to establish an international reserve bank, whose duty it would be to maintain the redemption of all national currencies in gold. A second method would be to ask the United States and neutral nations having excess gold to give or loan this gold to the nations requiring it. Details need not be here considered. It is enough to suggest that some such means must be devised to secure the necessary gold redistribution.

It remains to be added that such a redistribution of the world's gold would accomplish nothing if it were attempted as an isolated program of action. It could not possibly prove successful so long as European currencies and European budgets are in their present condition. Nor could it be successful if initiated through private agencies alone. Private programs of international financial co-operation of any kind always break on the rock of European politics. A program of economic co-operation can only hope to be successful if it is part of a program of political co-operation.

IV. National Budgets Must Be Balanced

Reduction of Expenditures Only Practical Means

We come now to the very heart of the problem of European rehabilitation. We have seen that expenditures in every continental belligerent country are far in excess of receipts, that neutral nations are no longer living within their means, and that even Great Britain will this year have a substantial deficit. It has been made clear, moreover, that persistently unbalanced budgets will in time wreck the entire financial and economic system. If Europe is to revive, gov-

ernment deficits must be eliminated—government expenditures and taxation receipts must be made to balance or chaos will in the end result.

We may as well recognize once and for all that taxes cannot be materially increased so long as present conditions prevail. Economically, the people cannot stand it; and politically, they will not. If economic conditions improve in consequence of the fulfilment of a program of reconstruction, the total of taxation receipts may, however, be raised without increasing the burden on the people. But as things now stand, the only practical means of balancing budgets lies in reducing expenditures.

That they must be drastically reduced is apparent from the budgetary figures presented in Chapter V. For convenience we may summarize here the estimated figures for France, Belgium, and Germany in 1921. They are as follows:[5]

(000,000 omitted)

	Expenditures	Receipts	Deficit
France (francs)	46,321	23,262	23,059
Belgium (francs)	9,689	5,108	4,581
Germany (marks)	110,200	40,000	70,200

The 1920 estimates for other continental countries will be found on page 56.

It will be seen that expenditures must everywhere be cut to the bone. Concretely, on the basis of the relatively favorable figures of 1920,[6] Italy must eliminate roughly two-thirds of her government expenditures; Germany two-thirds; Poland 80 per cent; France 50 per cent; Switzerland 30 per

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[5] See discussion of figures for all three countries on pages 49-56.

[6] The 1921 figures, it may be recalled, will in general be much worse than those of 1920.

cent; Spain 20 per cent; Holland 15 per cent; etc. It is clear enough that no minor economies will suffice.

Detailed and reliable classifications of expenditure in the various continental countries are not available. We may, however, compile a table for some of the leading countries which will indicate with rough accuracy the chief items of expenditure. The data are taken from a variety of sources.

Debt and Armament Expenditures of Leading European Countries

(000 omitted)

	Interest on Debt	Army	Navy
France (francs)	15,000,000	5,800,000	840,000
United Kingdom (pounds)	381,000	142,000	82,000
Italy (lira)	5,000,000	404,000	230,000

	Total Debt and Armament Expenditures	Total Expenditures	Percentage, Debt and Armament to Total Expenditures
France (francs)	21,640,000	46,321,000	47
United Kingdom (pounds)	605,000	1,195,000	50
Italy (lira)	5,634,000	28,450,000	20

Pensions should be added to these figures to ascertain the totals expended on past and present wars. French pensions amount to 3,650,000,000 francs, and British pensions, exclusive of old-age benefits, to £126,000,000. These additions bring the totals for military purposes up to 55 and 62 per cent respectively. Of the remaining French expenditures, about 75 per cent now go for the reconstruction of the devastated areas. In Italy, and in central and eastern Europe, subsidies designed to facilitate recovery from the war make up a very considerable portion of the total outlay. An indirect form of pension is, moreover, found in the padding of government pay-rolls for the purpose of taking care of deserving and needy persons. If added to the above these items would doubtless bring the amount expended on

past and future wars above 80 per cent of the total in nearly every country.

Data for the United States are more complete. The following table shows the distribution of our expenditures in 1920:[7]

DISTRIBUTION OF UNITED STATES EXPENDITURES, 1920

1. Past Wars	$3,855,482,586 =	68%
2. Future Wars	1,424,138,677 =	25%
3. Civil Departments	181,087,225 =	3%
4. Public Works	168,203,557 =	3%
5. Research, Education, and Health	57,093,661 =	1%
	$5,686,005,706 =	100%

Other compilations vary slightly from this; but the figures may be taken as approximately correct.

Disarmament Imperative

It is apparent from the foregoing tables that, if substantial reductions of expenditures are to be made, we must attack the items for past and future wars. A little may be lopped off here and there in administrative departments; but if such expenditures were entirely eliminated it would make but slight impression upon the staggering totals.

As regards past wars, pensions might perhaps be reduced somewhat, particularly if prices decline from the present high levels. Interest rates on government debts may also be reduced through refunding operations. We have already suggested that in the nations east of the Rhine domestic government bonds, along with paper money, should be largely eliminated through a process of redemption at some nominal rate. It may be that similar, though less drastic, measures will be necessary in some of the Allied

[7] Analysis made by Dr. Edward B. Rosa, of the United States Bureau of Standards.

belligerents; but in any event the rate of interest must be reduced. The more prices fall, the greater, of course, becomes the necessity of scaling down government fixed charges.

The difficulties and the practical limitations involved in scaling down pensions and debts are very great, however; and in any case they do not go to the root of the problem. While reducing interest and pensions reduces government exchanges, it also reduces the monetary income of pensioners and bondholders, and thus reduces tax-paying ability. The one real opportunity for balancing budgets lies in striking at the expenditures incurred in maintaining existing armies and navies and in preparing for future wars.

The following table indicates the extent to which the burden of militarism has increased since the Great War:

GROWTH OF ARMAMENTS AFTER WAR [8]

(000 omitted)

	ARMY		NAVY	
Country	1912	1921*	1912	1921*
Belgium	$ 13,119	$ 107,823	No Navy	
France	177,656	1,148,331**	$ 81,693	$167,799**
United Kingdom..	134,850	710,713†	216,194	410,605
Italy‡	83,284	80,815	41,859	45,712
Japan	47,066§	106,285	46,510§	176,072
United States	107,787	771,530	136,390	651,222

* Values of foreign money are calculated in dollars on a gold basis, as most nearly representing the burden upon the populations affected.
** Figures for year 1920.
† Including air force.
‡ Figures for fiscal years 1912–1913 and 1919–1920.
§ Figures for fiscal year 1912–1913.

With due allowance for changes in the level of prices, in every important country except Italy the burden of arma-

[8] From "The Staggering Burden of Armament," published by the World Peace Foundation, April, 1921, Vol. IV, No. 2, page 219.

ment has been enormously increased. The appalling truth is that this is occurring while every nation of Europe is either staggering under the load of taxation or else incurring huge annual deficits that threaten the early demoralization of the whole financial and economic system. Recall in this connection the analysis in Chapter X, of the effects of the British tax burden upon the curtailment of investments and the depreciation of existing plant and equipment. Recall the analysis in the same chapter of the process of financial and economic deterioration that results from persistent fiscal deficits. In the very face of imminent and far-reaching economic disaster, the nations of Europe, as well as Japan and the United States, go on increasing military expenditures. Europe as a whole now has larger armies than before the war, notwithstanding the substantial demobilization of the German forces. The race for naval supremacy by the substitution of new contestants has meanwhile been accelerated.

As late as October, 1921, with the French fiscal situation a matter of the gravest concern, the French Minister of War, with the support of the Premier, requests 91,000 additional men for the army of Morocco, 51,000 fresh troops for the army in the Levant, involving total expenditures of 927 million francs. To these new expenditures must be added 50 million francs for the work of the French High Commissioner in the Levant, not to mention the cost of the Corps of Occupation at Constantinople.

The real danger in Europe today is not, as French and British diplomacy conceives, the danger of military aggression of one nation against another; but it is the danger of national bankruptcy and consequent economic and social disintegration for all of them. It may be possible that in the conflict between economic need and military diplomacy, the latter will win; if it does, the financial bankruptcy of

nations will be inevitable. The drain of military preparation has always been a serious preventive to progress. In the present situation it cannot continue without absorbing the national savings, which should go into the maintenance and extension of national plant and equipment. If in the next few years we are to see nations inspired to action by bitter nationalist hatreds, and led by ignorant or unprincipled statesmen, arrayed against each other in arms, nothing but decadence lies before us.

Disarmament—thorough-going reduction of the naval and military establishments of the world—is the only certain means of preventing far-reaching economic and social disaster. No mere curtailment of the rate of increase of armaments, or limitation of military expenditures to their present appalling totals, will suffice to balance European budgets and place the world once more on the highroad to economic prosperity. Disarmament is an imperative necessity.

The road to disarmament lies through Paris. Unless and until France is given some sort of genuine assurance that she is not to be left to the mercy of a revengeful Germany, there can be no general reduction of military expenditures in Europe. An association of nations alone will make possible any effective guarantees, and, in consequence, any substantial alleviation of the burden of militarism.

Elements of the Problem

Summary of Reconstruction Program

Following this analysis of the numerous issues involved in a program of world reconstruction, it will help to an understanding of the problem as a whole if we now draw up in summary form the requirements of the situation and the policies that must be pursued by Europe and the United States.

I. The Fundamental Economic Requirements

1. Domestic production must be increased in every country.
2. Balanced international trade must be restored.
3. The gold standard must be restored.
4. National budgets must be balanced.

II. What Europe Must Do

1. Reduce reparation demands and cancel inter-European war debts.
2. Eliminate the tariff and trade barriers set up in the new countries of central and eastern Europe, and restore international transportation routes.
3. Reduce tariff and trade restrictions in western Europe, and abandon governmental support to national combinations for export trade and foreign exploitation.
4. Repudiate the vast bulk of the issues of paper currency and domestic bonds in central and eastern Europe, and reduce the paper circulation in the nations of western Europe.
5. Balance national budgets in all European countries, through a reduction of interest charges on government debts, governmental economy, and especially disarmament.

III. What the United States Must Do

1. Cancel Allied debts to the United States government.
2. Lower our own tariff duties.
3. Contribute a portion of our gold reserve for the restoration of the gold standard in Europe.
4. Make some additional loans for purely reconstructive purposes.
5. Reduce armaments.

Measures of Compulsion

It will be apparent that the United States is in a position to exert great influence upon Europe for the accomplishment of ends desired. There should be no necessity for exerting pressure for the purpose of saving Europe from destruction. But so powerful is the grip of European traditions, and so lacerated are the wounds of war, there is little hope that Europe will without some measure of outside compulsion adopt a co-operative program of reconstruction. Concretely, the United States may exert pressure through the following economic weapons:

1. That portion of the European debt to the United States which was not incurred for the purposes of the Great War.
2. The gold supply needed by Europe.
3. Further loans for European reconstruction.

These may be regarded as constructive weapons. There are, moreover, certain destructive lines of action at our command which may also be utilized to compel international co-operation:

1. We may lend the support of our government to export trade combinations and enter whole-heartedly into the game of territorial exploitation.
2. We may go in for imperialism and world military control.
3. We may isolate ourselves by the imposition of prohibitive tariff duties, leaving Europe to stew in her own grease.

While these retaliatory measures present a grim alternative to a program of constructive international action, one can conceive of a European attitude which would make them the only practical policy. If the present tendency toward

international chaos continues, it may well be argued that we should cut adrift from the sinking ship and attempt to save ourselves as best we may.

An Association of Nations Required

So much for the requirements of the situation—for the things that Europe must do, for the things that we must do, and for the influence which our position of power in the world now gives us. In the nature of things we can here present only the elements of the problem. The details of a program of reconstruction must be worked out by the statesmen of the world who are now in positions of administrative responsibility.

It may be pointed out, however, that there is no possibility of accomplishing the ends desired without an association of nations. The purely economic policies demanded cannot be administered without an effective international organization. Concretely, we must have what, for lack of a better name, may be called an International Tariff and Trade Commission. We must have an International Reserve Board. We must have an International Committee for Credit Allocation. We must have a Committee on Budgetary Control. We must have a Committee on Disarmament. Experience will show, moreover, that we must have various and sundry other committees to deal with the problems of exchange, of transportation, etc.

We have said that we must have an association of nations. We hold no brief for the existing League of Nations, especially since it is irrevocably tied to war settlements which the test of time has proved to be as vicious as they are unworkable. Nor do we care in the slightest what name is given to such an association. All that we insist upon is that world rehabilitation requires international organization and administration.

We recognize that many people will say that an association of nations and the accomplishment of the ends which we propose is impossible and visionary with human nature what it is. Is not super-government abhorrent to the fundamental tenets of society? It is undoubtedly just as abhorrent and just as impossible of attainment as was the formation and maintenance of the American nation out of a group of widely scattered colonies composed of different racial elements and of divergent economic interests. It is just as abhorrent and impossible of attainment as was the welding of the German Empire out of the disunited and belligerent states and principalities which at the middle of the last century made up central Europe from the Alps to the North Sea. It is just as impossible and just as abhorrent as the evolution of the empire of the Czar out of the discordant Slavic and Tartar tribes which straggled across the wastes of eastern Europe. It is just as abhorrent and just as impossible as the formation of the Swiss federation composed of French, Italian, and German racial units. It is just as abhorrent and impossible as these developments and no more so. The truth, of course, is that history is largely a record of the amalgamation of peoples and races into ever larger political organizations.

It should be clearly understood, however, that a workable association of nations does not require a surrender of national sovereignties and the erection of a superstate. All that is required is the development of international machinery for the purpose of administering policies agreed to by nations, in their sovereign capacities, which cannot be executed by nations acting independently of each other. An association of nations is, therefore, merely an instrumentality through which the real desires of the world for international co-operation can find expression and be given practical effect.

Campaign of Education Needed

It will be insisted, however, that in view of the present psychology of peoples and nations an international association of any sort is impossible. "Peoples still think in nationalistic terms." While the truth of this statement cannot be doubted, it does not follow that popular psychology never changes. What is the impossibility of today may become the actuality of tomorrow, either through the irresistible trend of events or from the dynamic strength of great leadership. Already, as we have seen, the pressure of European impoverishment is influencing the policies of the foreign offices of Great Britain and Italy, if not yet of France. Already the grim logic of economic events is forcing the United States into the arena of world affairs, through back alleys if not over the broad highway.

The first step in carrying out any program of reorganization must be a campaign of education, both in Europe and the United States. European peoples must be made to understand the fundamental requirements of the situation. They must be made to realize that only through international co-operation can economic and social disintegration be avoided. The people of the United States must also be made to appreciate the fundamental dependency of American prosperity upon the balance sheet of Europe. They must be educated to a point where they will demand of the American government a whole-hearted participation in a constructive program of international reconstruction, worked out through an association of nations.

The task belongs, in fact, to the spirit of liberalism throughout the world. Shaken to its very foundations during the war and trampled under the cloven hoof of post-war reaction and decadence, liberalism must arise again to lead in this crusade of economic and political enlightenment. A world-wide campaign of education and publicity is a

necessity. The truth about the economic plight of the world must be driven home to the masses of men and women everywhere. If we are to escape the cancerous decay which is now consuming the cell structure of society, the facts must be disclosed, with nothing hidden, nothing perverted, nothing exaggerated. Everyone must be brought to realize that the world is vastly poorer than before the war, and that nations cannot continue to live beyond their means without wrecking the economic organization of society. They must be brought to understand that against the forces of national disintegration there must be marshaled the forces of international co-operation. This is not a task for statesmen alone; it calls for the determined support of the press and the pulpit in every land.

Fearless Leadership Required

We cannot accept the view of the man high in the councils of Europe, who admits that the process of decay has fastened itself so fundamentally on the world that the cancerous growth can be removed only by cutting at the very foundations of society; and yet argues that even if the people knew the facts they would be unwilling to abandon their narrow nationalist prejudices and set to work on a program of international reconstruction. We believe that there is always in the body politic a great reserve of willing strength which will respond to leadership inspired by lofty ideals and rooted in truth and understanding. Throughout this critical era which has called aloud for intelligent and courageous leadership, one of the most disheartening phenomena is the never failing willingness of statesmen to shift the burden of responsibility to the people.

In the past, peoples have been governed by national ideals, and they have ever been found ready to make generous sacrifices for the promotion of these ideals. Today the

more closely interwoven relationships of nations require a broader horizen than that of nationalism. Fearless leadership must bring about an understanding of the crying need for closer international co-operation. Conferences behind closed doors, reports of experts, learned dissertations, will not suffice to enlist the spirit of men in this great cause. There is required a vital, inspired leadership to conduct a campaign for fair and honest international relations under an association of nations. Such a campaign should challenge the greatest leadership; for it involves the welfare and happiness of everyone and the very existence of millions of people.

This concludes all that the authors have to say, for the present. Let him who reads and doubts disprove the evidence of European decadence which threatens civilization; let him show that American prosperity is not indissolubly linked with the rehabilitation of Europe. Failing in this, he must either accept our constructive suggestions or formulate an alternative program of reconstruction. In either case the purpose of the authors will have been accomplished.

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